INCOME TAX PROCEDURE 1922

INCLUDING
FEDERAL CAPITAL STOCK TAX,
FEDERAL ESTATE TAX, AND SUPPLEMENT
TO EXCESS PROFITS TAX PROCEDURE, 1921

By

ROBERT H. MONTGOMERY, C. P. A.
of Lybrand, Ross Brothers and Montgomery; Attorney-at-Law; Former President, American Association of Public Accountants; Professor of Accounting, Columbia University

New York
THE RONALD PRESS COMPANY
1922

PREFACE

The 1921 federal tax law is a disappointment to 99 per cent of the citizens of the United States who are intelligent or interested enough to think or talk about it. The truth of the matter is that Congress did not have the courage to face the issue and enact an understandable tax law. There are only two kinds of income tax laws: one kind is short and simple and leaves much to the discretion of administrative officers; the other kind is long and complicated and in its endeavor to reach every one of a thousand items of income, to classify every one of a thousand items of deductions, to deny discretion to the Commissioner of Internal Revenue, it omits reference to items of income numbers 1001 and 1002; it fails to deal with items of deductions numbers 1001 to 1010; it neglects to specify how the Commissioner shall settle the omitted items, and thus comes chaos.

It is bad enough when there is enacted one law of the "long" type; but when such a law is enacted in 1913, a new one in 1916, the 1916 law is amended in 1917, a new law is enacted in 1918, is it any wonder that trouble arose when there was a unanimous demand for another new law in 1921?

The House of Representatives passed a law of the 1917 type on August 20, 1921. It attempted to merely amend the 1918 law. The Senate attempted to follow the same course but as it evolved 833 amendments to the House bill and as the House bill amended the 1918 law, the effect of 833 amendments to another series of amendments made strong men weep. And so the Senate passed a new bill, ignoring the 1918 draft, which after undergoing the usual changes in conference emerged on November 23, 1921, as the "Revenue Act of 1921."

The net result is that we have had five tax laws in less than nine years, and no one is satisfied!

I am strongly of the opinion that we should have another

very soon. It should be very short and very simple and it should leave to the Commissioner of Internal Revenue broad discretion. Then we should have a ten-year tax holiday so far as changes, other than in rates, are concerned.

I would increase the salaries of all responsible officers of the Bureau of Internal Revenue and in every way possible make service in the Bureau attractive so that it will be possible for the good men to remain with the Bureau and more good men to be taken on.

Even though the income tax is superseded by a general sales tax which administers itself, there are unsettled tax problems involving billions of dollars and the settlement of such problems should only be entrusted to men who have discretion, breadth of vision and high ideals regarding public service.

Unexpectedly I have had to rewrite almost entirely 1921 *Income Tax Procedure.* I did not at first realize that the important court and Treasury decisions during 1921, coupled with the new law, made so many radical changes in present procedure and made so many changes of a retroactive nature in former procedure.

It may be that in my opening remarks and in the book itself, I am unduly critical and it may be thought that there is a personal note in some of my comments. On the contrary, I benefit personally by the confusion. In my zeal for improvement in law and procedure I am trying to put myself in the position of the long-suffering taxpayer. In my occasional criticisms of the Treasury, I am absolutely impersonal. Surely I cannot pay any higher tribute to the present personnel of the Bureau of Internal Revenue than to suggest that a new law should give them almost unlimited discretion. I only know of one employee of the Bureau whom I would summarily remove; I know of many who are striving conscientiously and intelligently to interpret the regulations (by which they are bound) impartially. In defense of my disagreements with some of the new regulations and rulings, I may say that during the year 1921 the courts and the Treasury fully justified

many of the comments and criticisms appearing in the 1917 and succeeding editions of *Income Tax Procedure.*

The greatest curse has been the unsuccessful attempts to administer the laws as written, plus some very unintelligent and unjustified regulations. The new regulations (62) are a vast improvement over previous regulations. They very properly overrule some of the narrow and illegal interpretations and Solicitor's opinions which have appeared during the year 1921. In themselves, they further justify the criticisms which I make of such former rulings.

In response to several requests, I have devoted a chapter to the Federal Estate Tax, in the preparation of which I have had the valuable assistance of Orrin R. Judd, C. P. A., Trust Officer of the Columbia Trust Co., to whom my thanks are due.

It would be impossible to bring out a new book annually without the help of many associates. To a greater extent than ever before, I acknowledge the invaluable assistance of my partner, Walter A. Staub, C. P. A., and my assistants, J. Marvin Haynes, of the Bar of the District of Columbia, Hamilton Howard and Robert Buchanan. I am again indebted to my colleague at Columbia University, Professor Robert Murray Haig, for valuable assistance in the preparation of this volume, and I wish to repeat my expressions of appreciation of his work on former editions which is retained and which has met with the approval of those who have written to me from time to time. I also express my appreciation of the authoritative material contained in the Income and War Tax Services of the Corporation Trust Company, New York, which I used very freely with the company's kind permission.

ROBERT H. MONTGOMERY.

110 William Street, New York,
February 25, 1922.

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CHAPTER I

INTRODUCTORY

In the 1921 edition of this book the prophecy was hazarded that whatever Congress might accomplish in the direction of reforming the federal tax system in the year 1921, the income tax was reasonably certain to remain our chief source of revenue. The developments of the past twelve months have borne out this forecast. The year 1922 finds the income tax more firmly entrenched than ever before. Extended consideration of possible alternatives, such as a high tariff and a general sales tax, has not resulted in displacing the income tax from its primary position in the federal revenue system. Even though a tariff with high rates is passed, as now seems probable, its yield will not compare with the expected yield from the income tax. If a sales tax is passed, as now seems possible, it will probably be in addition to the income tax rather than in substitution for it.

Yield of the income tax.—During the fiscal year ended June 30, 1921, the income and profits taxes produced about three and one-quarter billions of dollars, a decrease of three-quarters of a billion as compared with the previous year. The exact figures for the past four years are as follows:

1918	$2,839,027,938.57
1919	2,600,783,902.70
1920	3,956,934,499.58
1921	3,225,790,653.00

The estimated collections of the Bureau of Internal Revenue under the new Revenue Act of 1921, for the years ending June 30, 1922 and 1923, are as follows:

Income Tax:	1922	1923
Individual	$850,000,000	$780,000,000
Corporation	430,000,000	545,000,000
Profits tax	600,000,000	150,000,000
Back taxes	230,000,000	300,000,000
Total income tax	$2,110,000,000	$1,775,000,000

Miscellaneous:	1922	1923
Estate tax	$150,000,000	$150,000,000
Transportation	135,000,000	....
Tobacco	250,000,000	250,000,000
Automobiles	110,000,000	110,000,000
Corporation capital stock tax	75,000,000	75,000,000
Other miscellaneous	412,730,000	457,280,000
Total miscellaneous	$1,132,730,000	$1,042,280,000
Total	$3,242,730,000	$2,817,280,000

This table shows that the income taxes are expected to yield 65 per cent of the total this year, and 69 per cent next year. Last year they yielded approximately 70 per cent. The abolition of the excess profits tax and the readjustment in the income tax promises to reduce the collections from income taxes by about one-third of a billion dollars.

Distribution of incomes.—Under the authority given in the law,[1] the Commissioner of Internal Revenue has published statistics compiled from the income tax returns.

Number of Personal Returns, Calendar Years 1917, 1918 and 1919, by Income Classes[2]

Income Classes	1917	1918	1919
$ 1,000 to $ 2,000	1,640,758	1,516,938	1,924,872
2,000 " 3,000	838,707	1,496,878	1,569,741
3,000 " 4,000	374,958	610,095	1,180,488
4,000 " 5,000	185,805	322,241	
5,000 " 10,000	270,666	319,356	438,851
10,000 " 15,000	65,800	69,992	
15,000 " 20,000	29,896	30,227	162,485
20,000 " 25,000	16,806	16,350	
25,000 " 30,000	10,571	10,206	
30,000 " 40,000	12,733	11,887	37,477
40,000 " 50,000	7,087	6,449	
50,000 " 100,000	12,439	9,996	13,320
100,000 " 150,000	3,302	2,358	2,983
150,000 " 200,000	1,302	866	
200,000 " 250,000	703	401	1,864
250,000 " 300,000	342	247	
300,000 " 400,000	380	260	425
400,000 " 500,000	179	122	
500,000 " 1,000,000	315	178	189
1,000,000 and over	141	67	65
Total	3,472,890	4,425,114	5,332,760

[1] Section 258.
[2] *Statistics of Income, Preliminary Report*, 1920, page 15; and *Statistics of Income*, 1922, page 4.

The changes in the groups in the three years is of considerable interest.

The total number of persons paying income tax increased from 3,472,890 in 1917, to 4,425,114 in 1918. It will be noted that the entire 1918 increase occurred among the comparatively small income tax payers, the number of returns filed in every group above the $20,000 line showing an actual decrease in number in 1918 as compared with 1917. The 1919 figures, on the other hand, show an actual increase all along the line as compared with 1918, and an increase, compared with 1917, up to incomes of $100,000.

Cost of administration.—The cost of collecting the income tax increased from 55 cents per $100 of tax in 1920, to 72 cents in 1921. This cost is still very low. Larger sums could profitably be spent in improving the administration of the tax, in increasing the number of districts, and in making more attractive the positions in the service. A thoroughly competent administrative force, adequate in size to the task it must perform, would diminish immeasurably the present burdens involved in complying with the law.

Income Taxation in the United States

Intelligent interpretation of the existing income tax statute is greatly facilitated by a knowledge of its history.[3] Indeed the great number of unsettled questions of law and procedure arising under acts in force in earlier years renders a knowledge of these acts almost indispensable to most persons who use this book. Consequently it is deemed desirable to trace the development of the statute, giving sufficient information to enable the reader, with the aid of the notes on

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[3] For a full discussion of the history of the income tax, see Edwin R. A. Seligman, *The Income Tax* (2nd edition, New York, 1914). For a detailed description of modern income tax systems, see K. K. Kennan, *Income Taxation* (Milwaukee, 1910).

"Former Procedure," to gain a clear conception of the evolution through which it has passed.

The present federal income tax is the latest of a series of such taxes to be imposed for national purposes in the United States, and it is not the only income tax being administered within the country at present, for several states utilize this source of revenue concurrently with the federal government. In fact, important as it is to the federal system, the taxation of incomes is of scarcely less interest to the several states, for it is now accepted as perhaps the most promising means of bringing about state tax reform.

State income taxation.—Because of the unhappy history of early attempts, state income taxes were viewed askance until Wisconsin, with a law introduced in 1911, demonstrated the practicability of such taxes.[4] The Wisconsin precedent was quickly followed by other states, including Connecticut, which began to tax corporations on this basis in 1915,[5] and Massachusetts, which passed a law of limited application in 1916.[6] A recent but important convert to the plan is the state of New York, which in 1917 imposed a franchise tax on manufacturing and mercantile corporations and in 1919 a personal income tax. The New York franchise law was amended in 1919 to make it more general in its scope and to increase the tax to a charge of 4½ per cent of the net income of corporations as reported to the Treasury for federal tax purposes[7] and was intended to be in lieu of all personal property taxes on those corporations. Its success paved the way for the state income tax of 1919, which imposes progressive rates on the incomes of individuals. The procedure under the New York statutes imposing income taxes on individuals and

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[4] Laws of 1911, Chapter 658.

[5] Acts of Conn., 1915, Ch. 292; *Bulletin of the National Tax Association*, February, 1916, page 8.

[6] Acts of Mass., 1916, Ch. 269; Chas. V. Bullock, *The Massachusetts Income Tax* (Boston, 1916).

[7] Modified in certain particulars.

corporations is treated by the author in a separate volume entitled *New York State Income Tax Procedure*, 1921.[8]

Evolution of the federal income tax law.—The present federal income tax is a recent development. Income taxes were imposed by the national government during the Civil War, when they were considered to be indirect in their nature and consequently beyond the constitutional prohibition.[9] One was imposed also in 1894; but a year later, when tested, it was declared unconstitutional by the Supreme Court, in the famouse case of *Pollock v. Farmers' Loan & Trust Company*,[10] on the ground that it was a direct tax and as such could only be imposed if apportioned according to population. Such an apportionment would lead to such monstrous economic consequences as to render a general income tax entirely unavailable as a federal financial resource until a constitutional amendment had been secured. The sixteenth amendment was finally passed eighteen years later. It provided that:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

The necessary number of states had ratified by February 25, 1913, but as a matter of convenience, March 1, 1913, is referred to as the date since which Congress has had the power to tax incomes without apportionment.

But even before the acquisition of this definite authority, Congress had passed the corporation excise tax of 1909, which was an income tax in fact although not in form. The evolution of the present statute dates from this act. The 1913

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[8] Those interested in the progress of the movement toward the taxation of income by the states will find the following articles valuable: Harley L. Lutz, "The Progress of State Income Tax Since 1911," *The American Economic Review*, March 1920; and Alzada Comstock, "Fiscal Aspects of State Income Taxes," in the same journal for June, 1920. A more comprehensive treatment of the subject will be found in Miss Comstock's *State Taxation of Personal Incomes* (New York, 1921).

[9] Seligman, *The Income Tax*, page 430 *et seq.*

[10] 157 U. S. 429, 39 L. Ed. 759; 15 S. Ct. 673; 158 U. S. 601, 39 L. Ed. 1108; 15 S. Ct. 912.

law widened the application of the tax to include individuals, and the laws of 1916, 1917, 1918, and 1921, represented definite developments and refinements, the more significant details of which are briefly described in the paragraphs which follow. In general there is evident a distinct trend toward elimination of arbitrary limitations on deductions, acceptance of established business customs and institutions, and recognition of the accountant's definition of profit and income.

THE CORPORATION SPECIAL EXCISE TAX OF 1909.—The act of August 5, 1909[11] (hereinafter referred to as "the 1909 law"), provided that every corporation[12] should "be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation . . . . equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year. . . . ." This law was declared constitutional by the Supreme Court of the United States[13] on the ground that it was an excise and not an income tax within the meaning of the federal Constitution, which, by clause four of article I, section 9, declares that:

> No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.

To all intents and purposes, except that of overcoming the constitutional difficulty, this was, of course, an income tax. The law directed that "net income" should be ascertained by deducting from gross income received certain costs, expenses paid and losses, but in the administration of the law its requirements as to income received and expenses paid were

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[11] 36 Stat. at L., C. 6, page 112; Comp. St. 1910, Supp. 1911, page 946; Pierce Fed. Code, Supp. §1036.

[12] "Every corporation, joint-stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company."

[13] *Flint v. Stone Tracy Co.,* 220 U. S. 107; 55 L. Ed. 389; 31 Sup. Ct. 342.

ignored, and corporations generally paid a tax based on net income as ascertained by commercial practice, i.e., by deducting expenses *accrued* (whether paid or not) from income *earned* (whether received or not). The Treasury forms and regulations were designed for and applied to net income, not net receipts.

The statute was brief and general in character, leaving to the administration much latitude in interpretation. However, one specific restriction was imposed: that upon deductions for interest paid—a feature which persisted in several later laws. The corporation could deduct interest actually paid on indebtedness only "to an amount of such bonded or other indebtedness not exceeding the paid-up capital stock of such corporation . . . . outstanding at the close of the year."[14]

Although passed late in the year, the law applied to the incomes of corporations as of the beginning of the calendar year 1909. Consequently the period during which incomes were affected by this act was four years and two months in length, extending from January 1, 1909, to February 28, 1913, when the 1913 law replaced it.

THE 1913 LAW.—Congress, almost immediately after the ratification of the sixteenth amendment, addressed itself to the task of formulating a general income tax law, and an act was finally approved October 3, 1913, effective as of March 1, 1913 (hereinafter referred to as "the 1913 law"). In spite of its many inconsistencies and ambiguities, this law must be acknowledged to have been on the whole an "intelligent and well-considered effort."[15] It was upheld as constitutional by the Supreme Court.[16] Many of the Treasury's interpretations, however, have not been upheld by the Supreme Court.

The personal exemption was high: $3,000 for a single person, with an additional $1,000 for a married couple. The

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[14] 1909 law, section 38, second.
[15] Seligman, *The Income Tax*, page 703.
[16] *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1; 60 L. Ed. 493; 36 Sup. Ct. 236.

former exmption of \$5,000 to corporations was, however, eliminated. The rates, compared with recent levels at least, were very low. A normal tax of 1 per cent applied to the total net income of individuals and corporations. Surtaxes, levied on individuals only, began with a 1 per cent rate when the net income reached \$20,000 and increased gradually to 6 per cent on those portions of incomes which exceeded \$500,000.[17] The yield the first year was approximately \$71,000,000.

Eagerness to prevent evasion and to secure a large yield was responsible for several restrictions upon deductions—restrictions which caused endless complications and irritations. Thus, individuals in deducting losses could subtract only those which were incurred "in trade." Deductions for depletion of mines, whether owned by individuals or corporations, were restricted to 5 per cent of the output. Corporations were forced to pay tax on dividends received from other corporations whether or not the other corporations were subject to income tax. The restriction upon interest paid by corporations, mentioned as a characteristic of the 1909 law, was continued by the 1913 law in another form. A corporation could now deduct interest on its indebtedness "to an amount of such indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year."[18]

The law granted to corporations the privilege of accounting on the basis of fiscal years rather than calendar years, but withheld it from individuals. Finally, the act adopted the English system of collection at the source, which had proved so effective in preventing evasion in Great Britain. This device, however, was the occasion of so great complaint from those charged with the duty of withholding the tax that after four years' experience it was abandoned in 1917.

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17 For a detailed table of the rates, see Chapter VII.

18 With several provisos including those designed to cover the cases of corporations with no capital stock and of corporations with indebtedness secured by collateral which was subject to sale as stock in trade. 1913 law, G (b).

THE 1916 LAW.—Three years after its establishment the income tax was called upon to produce a much larger revenue. Because of the effects of the European War, receipts from import duties had diminished, while the necessary expenditures of the federal government had greatly increased. To assist in meeting this emergency, income tax rates were raised. The normal rate applying both to individuals and corporations was made 2 per cent and the surtax rates upon individual incomes were made to range from 1 to 13 per cent. The lowest surtax rate applied as before upon income immediately above $20,000, and the highest rate on the portions of income exceeding $2,000,000.[19]

This law, passed September 8, 1916 (hereinafter referred to as "the 1916 law"), was made applicable to income received after January 1, 1916. Consequently the 1913 law was effective as to income received during a period of two years and ten months, from March 1, 1913, to December 31, 1915.

In general, the 1916 law, although a re-enactment of the 1913 law, was entirely recast in form and changed in a number of particulars. The changes for the most part had the effect of making the statute clearer and more practicable. March 1, 1913, was now definitely set as the date from which appreciations or depreciations of property values were to be measured for purposes of the tax. Stock dividends were specifically included in taxable net income, whereas the 1913 law had been silent on this point. Proceeds of life insurance policies transferred upon the death of the insured were declared to be exempt only when paid to individual beneficiaries.

Deductions were liberalized in two important particulars. Losses in transactions entered into for profit but not connected with an individual's trade or business were made allowable deductions, "to an amount not exceeding the profits arising therefrom."[20] Again, the arbitrary 5 per cent limita-

[19] For a detailed statement of the rates, see Chapter VII.
[20] 1916 law, section 5, fifth.

tion upon depletion allowances, a feature of the 1913 law, was eliminated and the way was opened for the full deduction of items of this character.

The 1916 law continued in effect for two years from January 1, 1916, to December 31, 1917. On October 3, 1917, the war income tax act was passed and had the force of a supplement to the 1916 law.

THE 1917 LAW.[21]—Although the 1916 law yielded about 360 millions, such a sum was entirely insufficient as the contribution from this source toward the tremendous expenses caused by our entry into the war. Consequently an act was passed on the fourth anniversary of the passage of the 1913 law, October 3, 1917 (hereinafter referred to as "the 1917 law"), which raised the income tax rates to a level never before approached in the history of civilization.[22] Thus after a very short period of administrative experience the income tax was put to the most severe test which a government ever had the courage to impose. It is greatly to the credit of both taxpayers and the Treasury that the system stood the test as successfully as it did.

This 1917 amendment was effective as of January 1, 1917, and remained valid for the period of one year.

In form, the 1917 law was an amendment to the 1916 law, the object apparently being to make possible the speedy repeal of the former without disturbing the law proper. This policy must now be declared to have been a mistaken one, for the confusion and difficulty caused by operating under the 1916 law, with its elaborate amendments, including two separate schedules of rates and two sets of personal exemptions, more than counterbalanced any advantages of the plan.

In addition to the 1916 taxes, a new normal tax of 2 per cent was imposed on individuals and a new 4 per cent rate on corporations, making the total normal rate 4 per cent, except

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[21]For a complete analysis, see *Income Tax Procedure,* 1918.

[22]Seligman, "The War Revenue Act," *Political Science Quarterly,* March, 1918, page 18.

on the income between $1,000 and $2,000, on which the rate was 2 per cent, and making the corporation tax rate 6 per cent. The surtaxes on individual incomes, which were to be levied in addition to the surtaxes existing under the 1916 law, ranged from 1 to 50 per cent and applied to all persons with taxable incomes of $5,000 or more. Consequently a tax rate of 67 per cent was applied to all taxable income accruing to an individual in excess of $2,000,000—2 per cent normal and 13 per cent surtax under the 1916 law, plus 2 per cent normal and 50 per cent surtax under the 1917 law.[23] For the purposes of the 1917 amendment the personal exemption was reduced from $3,000 to $1,000, with $1,000 additional for married couples, and, for the first time, a deduction of $200 was permitted for each dependent.

Various other changes were made in the law. The system of collection at source was virtually abandoned and a plan of "information at source" was substituted, thus removing a prolific source of irritation and embarrassment. The deduction of gifts by individuals to charitable, religious and educational institutions was permitted to an amount equal to 15 per cent of the net taxable income as calculated without making this deduction. On the other hand, limitations were imposed on several deductions, income and excess profits taxes being made non-deductible, as was interest on money borrowed for the purchase of tax-exempt securities. For the purpose of the new 4 per cent tax on corporations, however, permission was given to deduct the dividends on stock in other corporations.

The high rates established as the result of the passage of the 1917 law were, of course, expected to be temporary. To prevent corporations from avoiding the heavy 1917 tax through the simple device of postponing declarations of dividends until a period of lower rates arrived, Congress wrote a provision into the law which prescribed that dividends should be "taxed to the distributee at the rates prescribed by law for

[23] For a detailed statement of rates, see Chapter VII.

the years in which such profit or surplus was accumulated by the corporation."[24] The years of accumulation could not be arbitrarily selected by the corporation and, under the Treasury interpretation, the precise position of the distributions in the surtax scales of the previous years was determined by adding them to the net income of the current year. This provision was repealed by the 1918 law,[25] but in the short period during which it was in force it greatly complicated the administration of the law. Nevertheless it was essentially a just provision even though the prescribed method of applying the rates is open to criticism, and, having enacted it, Congress should have evolved some method of safeguarding the interests of the corporation which acted under it in good faith.

In 1917, also, excess profits taxes were introduced into the federal system. A law of this nature was passed March 3, 1917, but was repealed by the act of October 3, 1917, which imposed a heavy levy on supernormal profits as judged by the standard of invested capital. A full treatment of this act as well as of its successor of 1918 will be found in the author's *Excess Profits Tax Procedure,* 1921.

THE 1918 LAW.—The need for still greater revenues to meet the growing demands of the war, and an anxiety on the part of the Treasury to be relieved of some of the responsibility it had assumed by its liberal interpretation of the excess profits tax law of 1917, united with other causes to bring about a new Revenue Act for 1918. The law (hereinafter referred to as "the 1918 law") although not finally approved until February 24, 1919, affected incomes arising after January 1, 1918. It remained in force until the effective date of the new Revenue Act of 1921, which, for most of the provisions, is January 1, 1921.

The 1918 law was a complete statute, which replaced entirely the 1916 and 1917 acts, which had existed concurrently

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[24] 1917 law, section 1210.

[25] Except in the case of certain stock dividends. See Chapter XXIII.

during 1917. It was a comprehensive law which imposed a new version of profits tax, certain luxury taxes, and other internal revenue charges. Its text alone covered no less than 106 pages in the official edition. The technical task of drafting was well done, the language being for the most part clear, and the arrangement convenient; the form, in general, being greatly superior to that of earlier laws.

Rates applied to 1918 income exceeded even the record schedules of 1917. The normal rate and the corporation tax rate both were made 12 per cent, with a reduction to 6 per cent on the first $4,000 of the taxable income of a citizen or resident of the United States. These rates stood for one year only. After January 1, 1919, the normal rate applying to the taxable income of a citizen or resident of the United States became 8 per cent (4 per cent on the first $4,000) and the corporation tax rate dropped from 12 to 10 per cent. Thus there reappeared a discrimination of 2 per cent against corporate incomes similar to that which obtained in the year 1917.

Surtaxes on individual incomes ranged from 1 to 65 per cent, the highest rate applying to portions of income exceeding $1,000,000. The maximum total rate in 1918 was, consequently, 10 per cent higher than that which obtained in 1917, and the higher normal rate[26] and the steeper progression made the tax much heavier upon moderate incomes than the previous one.[27] The maximum total rate applied to 1919 and 1920 incomes was 73 per cent.

The 1918 law, while sufficiently complicated, was nevertheless more simple and equitable than its predecessor. One set of rates and personal exemptions replaced the double set in force in 1917, and many of the limitations and restrictions which, since the beginning, had hedged about the various deductions and caused endless confusion and complication, were

[26] In the case of earned incomes, the normal rate of 12 per cent was actually no higher for individuals than in 1917, because of the application in that year of the 8 per cent excess profits tax to professions and occupations in addition to the normal income tax of 4 per cent.

[27] For a detailed table of rates, see Chapter VII.

removed. Under the 1918 law, for the first time, an individual was permitted to deduct losses which are not incurred in trade. Also for the first time he was required to report upon the basis of his annual accounting period, even though that period did not coincide with the calendar year. Affiliated corporations were required to file consolidated returns.[28] Depreciation allowances were made more liberal. Depletion in the cases of mines and gas and oil wells was placed upon a very generous basis, with a special and rather artificial method provided for establishing "discovery value" in the case of properties owned by prospectors and "wild-catters." Special provision was made for charging off reasonable amortization on equipment which contributed to the prosecution of the war. Corporations for the first time were relieved of the arbitrary limitation on deductible interest, which had been in force since 1913, and of the discriminating tax on dividends received from other corporations. Income and excess profits taxes paid to other jurisdictions upon income arising therein were, under certain conditions, allowed as credits against the tax. A specific credit of $2,000 was granted corporations. The rule allocating dividends to the year earned, established in the 1917 law, was abandoned.[29]

As in the case of previous laws, partnerships were not taxed as such, the individual members, instead, being made liable on their distributive shares. The 1918 law introduced an innovation by putting in the same category with partnerships, certain corporations whose income was "to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor" (section 200). At the end of the taxable year the undistributed net income of each of these "personal-service corporations" was assigned for taxation to the stockholders in pro-

[28] Section 240.

[29] Except in the case of certain stock dividends. See Chapter XXIII.

portion to their holdings. They were relieved of the federal profits taxes, which would otherwise attach because of the corporate form of the enterprise. Under the 1921 law this class of personal service corporations was abandoned, effective December 31, 1921.

The Revenue Act of 1921

Due to the insistence of business men that the taxes levied by the 1918 law were unduly burdensome and were not well fitted to post-war conditions, both political parties during the presidential campaign of 1920 committed themselves to a revision of federal taxation. The Revenue Act of 1921, approved November 23 of that year, is the result of the pledge of the Republican Party. Although it came from the House of Representatives in the form of a series of amendments, it finally emerged from Congress as a complete new law. In fact it follows the phraseology of the 1918 law very closely and, while the changes are numerous and fundamental in character, the new law is essentially a rewritten draft of the 1918 law.

The provisions of the Revenue Act of 1921 (hereinafter referred to as "the 1921 law") are treated fully in the chapters which make up the body of this book, but it is desirable at this point to sketch briefly its main outlines and to make some general observations and criticisms.

Modifications made by the 1921 law.—The effective date of the new law is, for most purposes, January 1, 1921. Many of the most radical changes, however, do not come into force until one year later, January 1, 1922. This includes the sections which abolish the excess profits tax and the personal service corporation, increase the corporation tax rate, and establish the new class of "capital gains and losses."

In spite of what many considered to be a definite pledge and due largely to the influence of the "agricultural bloc," Congress finally declined to repeal the profits tax for 1921 but did

agree to abolish it thereafter. With it disappears the personal service corporation, which was, of course, a mere incident of profits taxation, devised to exclude corporations of a particular type from the application of such taxes. When the excess profits tax goes, the income tax rate on corporations rises from 10 to 12½ per cent. The change in the rate will cause corporations such as public utility corporations, which make only moderate profits, to pay higher taxes, but the total tax burden on corporate income is expected to be much lighter as will be seen from the statement of official estimates printed on page 3.

At the same time that these changes in the corporation income taxes are made, the surtax rates on individual incomes are scheduled for a reduction. A full table of the rates, old and new, is presented in Chapter VII. It will be noted that the change affects small taxpayers as well as large ones. The maximum rate remains very high—50 per cent, as compared with the maximum rate of 65 per cent under the 1918 law. The new 50 per cent rate applies to all income in excess of $200,000. The old rate, which applied to the increment of income above $200,000, was 60 per cent. Under the new scale, surtaxes do not begin until the $6,000 point is reached and are 1 per cent for incomes between $6,000 and $10,000. Under the old scale, the surtaxes begin at $5,000 and mount by more rapid steps. According to the estimates[30] these changes will not provide much relief for the individual taxpayers, however, for the government expects to get $780,000,000 next year with the changes in effect as compared with $850,000,000 this year.

The most revolutionary change in the new law is the establishment of the new division of income to be known as "capital gains." Beginning January 1, 1922, profits made by individuals arising from sales or exchanges of property "held for profit or investment," are subject to a maximum rate of 12½ per cent instead of the regular rates which, after that date,

[30] See page 3.

will range as high as 58 per cent (normal plus surtaxes).[31] The reason for the adoption of some such provision as this is plain, whatever one may think of choosing this particular method of meeting the situation. As everyone knows, many sales of property which have greatly increased in value since March 1, 1913, have been postponed or entirely blocked by the unwillingness of prospective sellers to take their profits when they would immediately become subject to heavy surtaxes in the year of realization. The solution adopted was practically to wipe out the offensive surtaxes on profits from this class of transactions.

It is too early to predict the effect of the provision. In some cases it will work beneficially; in general it complicates the procedure and discriminates against earned income instead of in favor of it. It will be taken advantage of by those who are able to work out plans of waiving interest and dividends and substituting therefor fixed gains.

The advantage to the investor in property conferred in the "capital gain" section is greatly accentuated by the provisions of the section prescribing the basis for determining gain or loss[32] which becomes effective as of January 1, 1921. Not only does this section adopt the so-called Frierson rule (which, in the case of property purchased before March 1, 1913, states that a profit or loss must be shown when comparison is made with original cost and be limited to the portion thereof which accrued after March 1, 1913), but it also liberalizes the definition of the closed transaction. The law now states positively that no gain or loss on exchanges of property for property shall be recognized unless the property received in the trade "has a readily realizable market value." Even though it has a readily realizable market value, one need not account for the gain in certain cases. This is one:

> . . . . When any such property held for investment or for productive use in trade or business (not including stock-in-trade or other

[31] 1921 law, section 206. This is hedged about by several restrictions. *Cf. infra,* Chapter XVII.

[32] Section 202.

property held primarily for sale), is exchanged for property of a like kind or use. . . . .

Other exceptions, covering cases of corporate reorganizations and sales of property to corporations, make it unnecessary to report many gains which have heretofore been subject to tax at the time the transaction was performed.

The new law takes an important forward step when it breaks away from the practice of refusing to permit a business loss in one period to affect the income of another accounting period. Section 204 (effective for 1921) permits, within certain restrictions, a net loss from business suffered in one year to be offset against any net income realized in the two next succeeding years. In other words, such losses may now be used to blot out subsequent gains, but losses are "outlawed" for this purpose after the expiration of two years. This change goes far towards rendering unnecessary any averaging device such as has been often urged as a means of making the income tax more equitable.

In addition to the reduced surtax rates, effective in 1922, the personal exemptions are made more liberal, the changes affecting the 1921 returns. In the case of a married person or a head of a family whose income does not exceed \$5,000, the exemption is increased from \$2,000 to \$2,500.[33] The allowance for each dependent is raised from \$200 to \$400.

A new provision regarding gifts requires the recipient, when he disposes of the gift, to account for the gain in the value of the gift in the hands of the donor before he parted with it. Another provision aims to prevent "wash sales" to establish losses. The law also recognizes, at last, reserves for bad debts as proper deductions. The Liberty bond exemptions are consolidated and simplified appreciably by another section.

The new law provides that personal service corporations shall be taxed as ordinary corporations from January 1, 1922, and incorporates a saving clause that if the Supreme Court declares invalid the method of taxing such corporations under

[33] For a full statement see 1921 law, section 216 (c).

the 1918 law, they shall be taxed as corporations from January 1, 1918. The basis of taxation of insurance companies is radically changed, as is that of businesses drawing the major portion of their income from sources within the possessions of the United States.

Affiliated corporations are given the option, from January 1, 1922, to file separate or consolidated returns. A clause is also inserted validating the requirement of consolidated returns (including even partnerships) under the 1917 law.

A Tax Simplification Board has been set up under the new law to investigate the procedure of the Bureau of Internal Revenue and to make recommendations for its simplification. The services to be rendered by this board should be of great value and should materially assist in making the administration of the law more effective.

Congress has at last realized that the Treasury should not be allowed to withhold indefinitely from taxpayers any taxes overpaid, without granting some compensation for the delay. The law now provides that the Treasury shall pay interest on taxes refunded.

Other changes in the law include a limitation of time for the filing of amortization claims; a provision that returns must be filed in all cases where an individual's gross income exceeds $5,000; a limitation on the deduction of interest paid to carry Liberty bonds; permission to deduct traveling expenses in full; and a change in the limitation periods for amended returns. Finally there are important changes in administrative features, such as the sections permitting binding agreements between the Treasury and the taxpayer, changing the procedure with reference to appeals and authorizing the Treasury to defer collection in cases of undue hardship.

All in all, the new law contains much that is good but also much which is open to serious criticism. It does not bear out the pre-election promises of the Republican Party. It is not a total loss; but it is a disappointment.

Undoubtedly progress is being made toward a more satis-

factory statute from the technical point of view, but much still remains to be done. Perhaps the most damning indictment which can be urged against the new statute is that it has increased rather than decreased the technical difficulties of arriving at net income. Instead of amplifying, it has complicated the problem and it has done so in order to achieve certain objects which in the end are not likely to commend themselves to the people of the country generally. Certainly to set up a new differentiation of income in order to discriminate against earnings as compared with property profits, does not seem to constitute real progress toward a permanently satisfactory solution of the problem.

Tax-exempt securities.—The high surtaxes on income have been the object of bitter attack recently on the ground that they are operating to force capital into tax-exempt securities. The relative attractiveness of tax-exempt municipal and state bonds has aroused those who are interested in private business undertakings which are dependent upon borrowed capital, and they demand either the exemption of interest on their securities or the elimination of all exemptions.

The plain facts are, of course, that the surtax rates are unreasonably high and that the amounts of tax-exempt securities available for investment are unreasonably large. The reduction of the surtax rates to the more moderate levels of the 1921 law helps the situation somewhat. At the same time the problem of the tax-exempt bond should be vigorously attacked. Active support should be given to the proposed constitutional amendment permitting the states and the federal government to tax the interest on all future issues. Certainly there is no solution in the direction of further extension of the principle of exemption. Tax-exempt securities must be reduced in amount, not increased. Unless this can be accomplished, the whole future of income taxation *at progressive rates* is seriously threatened.[34]

[34] See page 34.

Differentiation between earned and unearned income.—There is a growing sentiment in favor of relatively heavier taxation of unearned income. Such a change was recommended by the Treasury for the 1918 act. Largely because of the administrative difficulties involved, the suggestion was not adopted at that time. The question was made more important by the higher rates and lower personal exemptions established by the 1918 law.

It seemed probable that with all the time there was at their disposal, Congress between January and December, 1921, would have been able to work out a satisfactory plan. Instead of doing so, they continued old discriminations against earned incomes and included new ones. It cannot be possible that this discrimination in favor of the idle and the rich is intentional; it must be due to the incompetency and inattention of Congress.

Some maintain that the operation of state and local property taxes makes a sufficient discrimination between earned and unearned incomes. The burden imposed by local taxation upon property, while nominally comprehending personal property, usually falls heavily upon real estate only. Therefore a differentiation between earned and unearned incomes in favor of the former would undoubtedly increase the present heavy taxation of real estate in some communities. But where the real estate tax is already inordinately high, the remedy should be sought in a reform of the state as well as the local tax system.

Perhaps the greatest difficulty in differentiating between earned and unearned incomes lies in the distinction which will have to be made between income derived by an individual or partnership from the conduct of a business enterprise, and the dividends received by stockholders interested in a corporate enterprise engaged in the same kind of business. This apparent inequality will largely disappear if some means can be devised whereby those closely associated with the management of a corporation, as the officers and directors of a close

corporation, will be deemed to be in active business and entitled to the rate of tax applicable to earned incomes.

This distinction between "lazy" and "industrious" incomes, to use Gladstone's famous terminology, has been recognized in Great Britain since 1907 and appeals powerfully to the British people's sense of justice. There the differentiation is applied in the case of smaller incomes only, which materially simplifies the administrative problem. Inland Revenue officers consider this a simple distinction to establish in practice and the people generally believe it to be sound in principle.

Retroactive taxation.—The Revenue Act of 1918 was not approved by the President until February 24, 1919, two months after the close of the year whose incomes it subjected to tax. President Harding signed the 1921 law on November 23, 1921, three months earlier than President Wilson signed the 1918 law, but still at least eleven months later than it should have been. The legality of this action appears to be beyond question,[35] but its practical economic wisdom is quite another matter. It is of the highest importance that taxpayers should know in advance what their tax burden is to be. It is also important that they should not be put to serious inconvenience by being asked to master radical changes in complicated statutes within a few weeks before the returns are due. Congress has shown a strong disposition to postpone action on revenue measures and to take advantage of the fact that retroactive legislation of this type is not unconstitutional. In the presence of an overwhelming emergency such as may be occasioned

[35] Decision. "It is clearly . . . . constitutional as well as expedient, in levying a tax on profits or income, to take as the measure of taxation the profits or income of a preceding year. To tax is legal, and to assume as a standard the transactions immediately prior is certainly not unreasonable, particularly when we find it always adopted in exactly similar cases." (*Drexel v. Commonwealth,* 46 Pa. St. 31.)

See also *Brushaber v. Union Pacific R. R. Co.,* 240 U. S. 1; 36 Sup. Ct. 236; 60 L. Ed. 493.

For a full discussion as to the extent to which the laws of 1913 to 1918 were retroactive, see *Income Tax Procedure,* 1919, pages 30-32.

by rapidly changing conditions during a war such legislation may be excused, but under present conditions there is no adequate reason why that legislation affecting a current year's income should not be completed early in the year.

The Plan of the Book

Due to the repeal of the excess profits tax as of January 1, 1922, it has been considered unnecessary to issue a separate volume, as in 1921, dealing with that subject. Instead, all new rulings regarding the excess profits tax are presented in an appendix to this volume.

A chapter on the federal estate tax has been added in this edition. The federal capital stock tax chapter which was transferred to *Excess Profits Tax Procedure* in 1921, reappears in this volume as Chapter XLI.

Two features of the book's arrangement should perhaps be emphasized. One is the policy of quoting exactly from law and regulations all material of importance in considering questions connected with the preparation of returns. Since the construction often turns upon a single word or punctuation, it seems to the author important to make the precise official language available in convenient and easily recognizable form. The source of all material quoted in the text is plainly indicated, the excerpt being labeled "law," "regulation," "decision," etc., as the case may be. It should be noted that regulations quoted in the text are taken from official Regulations 62 unless otherwise specified. A quoted regulation bearing as a reference merely an article number is to be considered as coming from this source.

All material changes in the new regulations as compared with Regulations 45 are commented upon. A regulation without comment is the same as the corresponding article in Regulations 45.

Since early in 1920 and including rulings issued prior, the Treasury has issued a series of official bulletins containing

decisions, opinions and rulings by the Attorney General, Solicitor of Internal Revenue, and the Committee on Appeals and Review and many "office" decisions. All of these have been carefully reviewed. Those of importance are quoted in full. When the author disagrees with the Treasury his reasons are stated.

The following abbreviations are used by the Treasury in these bulletins:

Ct. D.	Court Decision
T. D.	Treasury Decision
Op. A. G.	Opinion of Attorney General
S.	Solicitor's Memorandum
O. or L. O.	Solicitor's Law Opinion
Sol. Op.	Solicitor's Opinion
T. B. R.	Advisory Tax Board Recommendation
T. B. M.	Advisory Tax Board Memorandum
A. R. R.	Committee on Appeals and Review Recommendation
A. R. M.	Committee on Appeals and Review Memorandum
O. D.	Office Decision
Mim.	Mimeograph letter
C. B.	Cumulative Bulletin (No. 1 covers 1919; No. 2, January-June, 1920; No. 3, July-December, 1920; No. 4, January-June, 1921)
I. T.	Income Tax Unit
E. T.	Estate Tax Division
C. S. T.	Capital Stock Tax Division
A. B. C., etc.	Represent names of individuals
M. N., X. Y. Z., etc.	Represent names of corporations, places of business, according to context
x.	Represents a certain number

Rulings issued prior to January 1, 1922, were cited by the Treasury as 1-21-1369, meaning Bulletin No. 1 of 1921, Ruling No. 1369. A new series of bulletins has been issued for 1922 in which the method of reference is different. Rulings are now quoted as I-3-27, meaning Volume I (of the new series, Bulletin No. 3, Ruling No. 27.

The author has indexed all bulletin rulings issued prior to July, 1921, to the pages of the Cumulative Bulletins upon

which they appear. Thus C. B. 3, page 23, O. D. 587, shows that the quotation is from Office Decision 587 which will be found in full on page 23 of Cumulative Bulletin No. 3 (July-December, 1920). Rulings issued subsequent to July 1, 1921, are referred to by number, as the Cumulative Bulletin for July-December, 1921, is not yet published. 1922 rulings are quoted as shown in the 1922 bulletins.

The second feature to which attention should be drawn is the treatment of former procedure. Because of the large number of returns for previous years which are as yet unaudited by the authorities, it is deemed desirable to include in footnotes the facts concerning the law and procedure which formerly obtained wherever important changes have been made This makes it possible for the book to serve as a guide when questions arise in regard to old returns.

PART I

APPLICATION AND ADMINISTRATION

CHAPTER II

APPLICATION OF THE LAW
CORPORATIONS EXEMPT FROM TAXATION

The tax is imposed upon "net income,"[1] a term minutely described in the law. In the case of individuals[2] it means the gross income, which includes earnings from personal services, business and trades, profits from sales of property, interest, rents, royalties, dividends, etc.,[3] less deductions for expenses, losses, interest, taxes, depreciation, etc.[4] The surtax, which commences at an amount in excess of $5,000 for 1921 and of $6,000 for 1922, is calculated upon the total net income as thus established.

To determine the basis for the 8 per cent normal tax[5] of an individual, there are certain deductions (or "credits," as they are called) for dividends, interest on Liberty bonds, etc., the personal exemption of $1,000, $2,000, or $2,500, and the exemption for dependents.[6] The first $4,000 of the amount so determined is subject to a normal tax of only 4 per cent[7] in the case of citizens or residents of the United States.

The gross income of corporations includes the same items as for individuals,[8] but the deductions are not quite the same.[9] The net income of corporations is taxed 10 per cent for the calendar year 1921, in addition to the excess profits tax. The flat rate is increased to 12½ per cent for subsequent years.

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[1] Sections 210, 230 (a).
[2] Section 212 (a).
[3] Section 213.
[4] Section 214.
[5] For the year 1918, the rate was 12 per cent. The rate for 1919 and 1920 was 8 per cent.
[6] Section 216.
[7] For the year 1918 the rate was 6 per cent. The rate for 1919 and 1920 was 4 per cent.
[8] Section 233.
[9] The chief differences are deductions which are permitted individuals for losses not connected with business or trade, and for gifts.

The excess profits tax is repealed as of December 31, 1921. Moreover, there are certain subtractions from corporate incomes which are allowed under the title of "credits," a device adopted in order to make the meaning of the term "net income" that which is to be taxed for excess profits. For a full discussion of credits see Chapter XII.

The various types of taxable income included under the provisions of section 213, and the allowable deductions permitted by sections 214 and 234, are discussed in detail in the series of chapters which constitute Parts II and III of this book.

Exempt Income in General

It is pertinent at this place to discuss in a general way income which is partially or wholly exempt from taxation.

Exempt income can be divided into four classes:

1. Income which is exempt from all taxes imposed by the 1921 revenue law because it is received by certain types of corporations or by states or by the political subdivisions thereof. This class is dealt with later in this chapter.
2. Income which is exempt because, geographically, it lies beyond the scope and application of the law. (See Chapter XII.)
3. Income such as is not included in either of the above classes, which is exempt from both normal tax and surtaxes. Such items are not included in gross income. (See Chapter XII.)
4. Income such as is not included in any of the above classes, which is exempt from normal tax but is subject to surtax. (See Chapter XII.)

The first class can be called an "exemption of the person," while the other three are "exemptions of the income."

No individual[10] is entirely exempt from the tax merely be-

[10] This statement includes minors. See Chapter IV.

cause of his status or character as an individual unless one construes the personal exemption as an exception to this statement. That exemption, of course, operates to relieve entirely from taxation the person whose income is smaller than the specified amounts.

If one should receive all his income from interest upon the obligations of a state or of any political subdivision thereof, or upon certain of the obligations of the United States or its possessions or securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916, he would be subject to no income tax and would not be required to make any return. He might receive and enjoy his income as if the tax did not exist. This is true even though, in addition, he receives taxable income of any amount less than $1,000 (single person) during the year. If he receives more than $1,000 of such additional taxable income, he would proceed in the same manner as any other taxpayer.

Also, taxpayers who receive dividends from the stock of American corporations subject to the income tax, or who receive interest on certain government securities, are exempt from the normal taxes on such income but are nevertheless required to report such items annually if their total net income is large enough to justify them in making any return at all, or if their gross income exceeds $5,000.

Another classification of exempt income has been made as follows:[11]

1. Granted for fiscal or administrative reasons:
   - (a) Deductions necessary to tax true or net income only (ordinary and necessary expenses).
   - (b) Credits required to avoid double taxation (dividends, proceeds of insurance policies, and inheritances).
2. Granted for constitutional reasons:

   Interest from state and municipal obligations; salaries of state and municipal employees. (Amount of state and municipal securities withdrawn from the federal income

[11] Rufus S. Tucker "Exemptions under the Federal Income Tax," *Bulletin of the National Tax Association,* Volume 5, page 138.

tax is at least $4,000,000,000, representing an annual income of $160,000,000.[12]

3. Granted for reasons of public welfare:
   (a) Personal exemptions of $1,000 and $2,000, on the ground of inability of such small incomes to pay a direct tax.
   (b) In Prussia before the war the limit of exemptions was $220 and no European country had as high an exemption as $1,000. Raising the exemption would increase the number of citizens who do not knowingly contribute to the cost of government.
4. Granted to assist certain kinds of enterprise or to encourage certain forms of investment, presumably—
   (a) Income from bonds of the United States, its territories and possessions, farm loan bonds, and bonds of the War Finance Corporation.
   (b) Organizations not operating primarily for profit.

Exempt Corporations

Certain corporations are expressly exempt from the provisions of the law.

Types of corporations exempt.—The law groups the exempt corporations under fourteen heads:

LAW. Section 231. **That the following organizations shall be exempt from taxation under this title— . . . .**

LABOR, AGRICULTURAL OR HORTICULTURAL ORGANIZATIONS.—

LAW. Section 231. . . . . **(1) Labor, agricultural, or horticultural organizations;**

REGULATION. Agricultural or horticultural organizations exempt from tax do not include corporations engaged in growing agricultural or horticultural products or raising live stock or similar products for profit, but include only those organizations which, having no net income inuring to the benefit of their members, are educational or instructive in character and have for their purpose the betterment of the conditions of those engaged in these pursuits, the improvement

[12] "It is estimated that there are outstanding perhaps $10,000,000,000 of fully tax exempt securities." Letter from Secretary of the Treasury Mellon to Chairman Fordney of the Committee on Ways and Means, April 30, 1921.

of the grade of their products, and the encouragement and promotion of these industries to a higher degree of efficiency. Included in this class as exempt are organizations such as county fairs and like associations of a quasi-public character, which through a system of awards, prizes, or premiums are designed to encourage the production of better live stock, better agricultural and horticultural products, and whose income, derived from gate receipts, entry fees, donations, etc., is used exclusively to meet the necessary expenses of upkeep and operation. Societies or associations which have for their purpose the holding of annual or periodical race meets, from which profits inure or may inure to the benefit of the members or stockholders, do not come within the terms of this exemption. A corporation engaged in the business of raising stock or poultry, or growing grain, fruits, or other products of this character, as a means of livelihood and for the purpose of gain, is an agricultural or horticultural society only in the sense that its name indicates the kind of business in which it is engaged, and it is not exempt from tax. (Art. 512.)

The foregoing regulation makes it clear that many so-called mutual organizations are subject to the tax.

Ruling. The X Company is a business activity organized for the purpose of affording employment to the members of a certain labor union. It is not a part of the union as such, although it is owned and controlled by the union. Wages are paid to the members employed, and all profits, after paying expenses, are turned into the treasury of the union.

Held, that the activities of the company are such as to make it a business enterprise. Hence it does not come within the exemption as a labor organization provided in section 231 (1) of the Revenue Act of 1918, and will, therefore, be required to file returns of net income. (C. B. 2, page 211; O. D. 523.)

Mutual savings banks.—

Law. Section 231. . . . . **(2) Mutual savings banks not having a capital stock represented by shares; . . . .**

Regulation. A Massachusetts savings bank, otherwise exempt, which establishes an insurance department under the statutes of that State, does not thereby become subject to tax upon the income received by such department. (Art. 513.)

Ruling. A savings bank within the accepted meaning of the term contemplates the ordinary institution of that kind as organized and conducted in accordance with the statutes of the various States. Its manner of investing the savings of depositors is restricted. Furthermore, the funds are received by deposits ordinarily made, rather

than by a contract under which there arises a binding duty to make future deposits. Therefore an organization which receives deposits from its members by contract under which there arises a binding duty to make future deposits, and which is operated for the purpose of speculation rather than for savings, is not a mutual savings bank within the meaning of section 231 (2) of the Revenue Act of 1918. (C. B. 4, page 262; O. D. 780.)

FRATERNAL BENEFICIARY SOCIETIES.—

LAW. Section 231. . . . . **(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents; . . . .**

REGULATION. A fraternal beneficiary society is exempt from tax only if operated under the "lodge system," or for the exclusive benefit of the members of a society so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits. (Art. 514.)

The two rulings which follow indicate the Treasury's interpretation of the law and regulations.

RULING. The M association is an incorporated society operating under the lodge system throughout the United States, its charter providing for the union of eligible members into a grand fraternal beneficiary, educational and patriotic society. Assessments are levied upon its members to provide for the payment of sick and death benefits, for disability relief in case of accident and for promoting their social, moral, educational and patriotic advancement. It also derives income from subscriptions to a daily and a weekly newspaper which it publishes as well as from job printing and other sources. None of the income inures to the benefit of any private stockholder or individual.

Held, that although this society has fraternal and benevolent features it is chiefly a patriotic organization interested in the general welfare of its members and that its powers are so extensive as to preclude its classification under paragraph 3, section 231 of the Revenue Act of 1918. (C. B. 3, page 207; O. D. 508.)

It would appear from the facts as stated that the Treasury has placed a very narrow interpretation on the law.

Ruling. A fraternal beneficiary society is a society whose members have adopted the same or a very similar calling, avocation or profession, or who are working in unison to accomplish some worthy object and who for that reason have bound themselves together as an association or society to aid and assist one another and to promote the common cause. The term "fraternal" can properly be applied to such an association for the reason that the pursuit of a common object usually has a tendency to create a brotherly feeling among those who are thus engaged. The absence of profit in the operation of such an association is not the test as to whether it is within the exemption as a fraternal beneficiary society, but the want of a fraternal side or object which it is in some manner organized to promote. A fraternal beneficiary society may be a mutual insurance company, but must be something more; it must be primarily fraternal and also, in order to fall within the exemption provided for by section 231 (3) of the Revenue Act of 1918 must be operated under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system. (See *Commercial Travellers Life and Accident Association v. Rodway*, 235 Fed. 370.) (C. B. 3, page 236; O. D. 690.)

Building and loan associations.—

Law. Section 231. . . . . **(4) Domestic building and loan associations; substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profits; . . . .**

The principal tests applied to a building and loan association to determine its right to exemption, are whether the members share in the profits on practically the same footing and that substantially all its business is confined to making loans to members.

Regulation. In general, a building and loan association entitled to exemption is one organized pursuant to the laws of any State, Territory, or the District of Columbia, which accumulates funds to be loaned primarily to its shareholders for the purpose of building or acquiring homes. In order to be exempt the association (1) must be mutual, that is, all of its stockholders or members must share in the profits on substantially the same footing; and (2) must be operated so that substantially all of its business is confined to the making of loans to bona fide shareholders. A building and loan association otherwise exempt does not lose its exempt status because—

(1) It has paid-up shares which are (*a*) preferred as to earnings,

and (*b*) have a definite rate of interest which may be higher than the rate of dividends paid on other stock.

(2) It borrows money (accepting deposits is held to be a form of borrowing) which it uses for loans to shareholders, the dues, fines, and penalties paid by shareholders being inadequate for this purpose.

(3) It makes loans to nonmembers from accumulated funds which are not needed for loans to shareholders. In any such case, however, the burden will be upon the association to show that substantially all of its loans are made to members.

(4) The amount of its prepaid or full-paid stock is disproportionate to running or installment stock, provided the issuance of such prepaid or full-paid stock is ancillary to the furtherance of the main business of the association; that is, that it is intended to provide a fund from which loans may be made primarily to persons subscribing to running or installment stock to enable them to acquire or build homes.

Cooperative banks without capital stock organized and operated for mutual purposes and without profit are exempt. Credit unions such as those organized under the laws of Massachusetts, being in substance and in fact the same as cooperative banks, are likewise exempt from tax. (Art. 515.)

The new article paraphrases the old one, no essential change being made therein.

Rulings. Where a large proportion of the loans of an association are made upon such securities as stocks, automobile notes and personal endorsements and only a small proportion upon real estate, it is held that such an association is not a domestic building and loan association within the meaning of section 231 (4) of the Revenue Act of 1918, and must file returns of annual net income and pay any tax shown to be due thereon. (B. 44-21-1900; O. D. 1088.)

A building and loan association which loans its funds to nonmembers, on endorsed notes, a very small amount only being secured by real estate, and divides the profits among the holders of the paid-up certificates, these being the only members of the association participating in the management and in the profits, is held to be engaged in business in the nature of a banking business, and does not come within the exemption provided in section 231 (4) of the Revenue Act of 1918. (C. B. 4, page 262; O. D. 768.)

A building and loan association which conducts an insurance agency and sells insurance is not entitled to exemption under section 231 (4) of the Revenue Act of 1918. (B. Digest 49-21-1965; O. D. 1129.)

CERTAIN CEMETERY COMPANIES.—

LAW. Section 231. . . . . **(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual; . . . .**

REGULATION. A cemetery company in order to be exempt must be owned and operated exclusively for the benefit of its lot owners or must not be operated for profit. Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual, is exempt from income tax. A cemetery company of which all lot owners are members, issuing preferred stock entitling the holder to a semiannual dividend of 4 per cent, and whose articles of incorporation provide that the preferred stock shall be retired at par as soon as sufficient funds are realized from sales and that all funds realized in addition thereto shall be used by the company for the care and improvement of the cemetery property, is within the exemption. (Art. 516.)

The wording of the new regulation is changed to give effect to the additional requirement of the 1921 law, that profits do not inure to the benefit of private stockholders or individuals.

RULING. A cemetery company, in order to be exempt under section 231 (5) of the Revenue Act of 1918, must be owned and operated exclusively for the benefit of all lot owners. (B. Digest 39-21-1846; Sol. Op. 120.)

RELIGIOUS, CHARITABLE, EDUCATIONAL, ETC., SOCIETIES.—

LAW. Section 231. . . . . **(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals,[13] no part of the net earnings of which inures to the benefit of any private stockholder or individual;**

REGULATION. This exemption applies to corporations, associations, and community chests, funds, or foundations. In order to be exempt, the organization must meet three tests: (*a*) it must be organized and

[13] **[Former Procedure]** The societies for the prevention of cruelty to children or animals were included for the first time in the 1918 law.

operated for one or more of the specified purposes; (*b*) it must be organized and operated exclusively for such purposes; and (*c*) no part of its net income must inure to the benefit of private stockholders or individuals.

(1) Charitable corporations include an association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by improving the efficient administration of justice. Educational corporations may include an association whose sole purpose is the instruction of the public. This is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose. But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute. Scientific corporations include an association for the scientific study of law, to the end of improvement in its administration.

(2) Where a religious corporation owns a large quantity of farm land and works it, and also manufactures and sells clothing and other articles for profit, it is not operated exclusively for religious purposes and is not exempt, even though its property is held in common and its profits do not inure to the benefit of individual members of the society.

(3) It does not prevent exemption that private individuals, for whose benefit a charity is organized, receive the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders. If, however, a corporation issues "voting shares," which entitle the holders upon the dissolution of the corporation to receive the proceeds of its property, including accumulated income, the right to exemption does not exist, even though the by-laws provide that the shareholders shall not receive any dividend or other return upon their shares. (Art. 517.)

This article now includes community chests, funds, or foundations, and literary societies. The inhibition against orchestral societies and against trusts, the income of which is used for religious purposes, is now removed.

Rulings. The M Hospital Association was incorporated under the laws of the State of Y to build, own, lease, acquire, and operate a hospital to furnish and provide medical, surgical, and hospital

services and care to all employees of other corporations, persons, or partnerships with whom contracts may be made. Said services are intended to take care of the needs of sick and injured employees requiring and entitled to such care by virtue of membership in said corporations and in conformity to the provisions of the by-laws of the corporation and the care of injured employees as contemplated and provided for in the laws of the State of Y and the rules, regulations, and practices now or hereafter promulgated by the State Medical Aid Board. The corporation also contemplates hospital services and care for the families of employees and for other persons.

The income of the association is received from the corporations with which it has contractual relations, from the Medical Aid Department of the State for services to injured employees who do not have contract arrangements, and from direct payments by patients. No patients are treated free, but where destitute patients have been admitted as objects of public charge the services are rendered at cost to the municipal corporation paying for such services.

Based upon the foregoing facts, it is held that the M Hospital Association is not a charitable organization within the meaning of section 231 (6) of the Revenue Act of 1918, and that it will be required to file returns of annual net income and pay any tax shown to be due. (B. 33-21-1769; O. D. 993.)

A memorial fund of which the M Corporation is trustee is controlled by a board of directors. It is organized not to engage in a charitable undertaking itself, but to distribute its income to charitable institutions and to worthy individuals. Held, it is not a charitable corporation or association within the provisions of section 11 (a) Sixth of the Revenue Act of 1916 as amended, or section 231 (6) of the Revenue Act of 1918.

To hold such an organization exempt and relieve it from filing returns of income and paying taxes thereon would in effect delegate to it authority to determine what institutions and gifts are charitable, which is not permissible.

Consequently, contributions made to such a fund are not deductible under section 5 (a) Ninth of the Revenue Act of 1916 as amended, or section 214 (a) 11 of the Revenue Act of 1918. (C. B. 4, page 264; O. D. 872.)

A private corporation without capital stock was organized and is operated under State laws and managed by a board of trustees for the purpose of conducting a school to educate and train men and women in those subjects that will prepare them for practical business and commercial and industrial occupations. It derives its income from tuition fees paid by students attending its courses. After payment of expenses the balance remaining is placed in an operating fund to meet operating expenses in the future. If this operating fund exceeds

the current year's income, any amount in excess of 25 per cent is placed in a students' loan fund from which deserving students may borrow money for the purpose of pursuing a course of study in the school. No part of the earnings of the school inures to the benefit of any individual or individuals connected with the corporation in any manner whatever, and the by-laws provide that no remuneration of any kind shall be paid to the board of trustees for their services as such.

The corporation is held to be exempt from taxation under the provisions of section 231 (6). (B. 46-21-1923; O. D. 1102.)

A corporation organized for the purpose of conducting a military school for profit, the stock of which is owned entirely by the officers, directors, and teachers of the institution, is not exempt from income tax as an educational institution no part of the net earnings of which inures to the benefit of any private stockholder or individual within the meaning of subdivision 6, section 231, Revenue Act of 1918.

The term "private" is not used in the statute in contradistinction to "official," whether the latter be used in a military or an institutional sense, but as the antonym of "public," the supposed beneficiary of the benevolent activities of an institution devoted exclusively to public betterment; private pecuniary profit and gain is the test to be applied, and the officers, directors, and teachers of a military school corporation, owning the stock thereof, are "private stockholders" within the meaning of the Act. (C. B. 4, page 266; T. D. 3164.)

A publishing corporation which is primarily religious in character, but not exclusively so, does not come within the exemption provided in section 231 (6) of the Revenue Act of 1918. (B. Digest 51-21-1983; O. D. 1142.)

A lyceum and Chautauqua association was organized to take over the assets of a partnership for the purpose of promoting the intellectual, social, physical, moral, and nonsectarian religious welfare of the people in the places where it operates and especially in the United States.

Its income is received from admission charges to its entertainments. The income is used first to defray expenses of operating; second to the payment of the members of the partnership for assets purchased, and third, to build up a surplus. The members of the partnership whose assets were taken over were made life members of the board of trustees.

Held, that the association is engaged in an ordinary business enterprise and is precluded from exemption under any of the provisions of section 231 of the Revenue Act of 1918. (B. 43-21-1886; O. D. 1077.)

CHAMBERS OF COMMERCE, ETC.—

LAW. Section 231. . . . . **(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual; . . . .**

REGULATION. A business league is an association of persons having some common business interest, which limits its activities to work for such common interest and does not engage in a regular business of a kind ordinarily carried on for profit. Its work need not be similar to that of a chamber of commerce or board of trade. The fact that it engages in a regular business of a kind ordinarily carried on for profit but on a cooperative basis or so as to produce only sufficient income to be self-sustaining, is not ground for exemption. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not such a league, since its members have no common business interest, and it is not exempt, even though all of its income is devoted to the purpose stated. A clearing house association, not organized for profit, no part of the net income of which inures to any private stockholder or individual, is exempt provided its activities are limited to the exchange of checks and similar work for the common benefit of its members. An association of persons who are engaged in the business of carrying freight and passengers by boats propelled by steam, which is designed to promote the legitimate objects of such business, and all of the income of which is derived from membership dues and is expended for office expenses and the salary of a secretary-treasurer, is exempt from tax. An incorporated cotton exchange whose shares carry the right to dividends is organized for profit and is not exempt. (Art. 518.)

The only change in this regulation is the insertion of the third sentence which contains the substance of a 1921 ruling (C. B. 4, page 266; O. D. 786).

CIVIC LEAGUES.—

LAW. Section 231. . . . . **(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare; . . . .**

REGULATION. A corporation having capital stock and possessing a charter which authorizes it to buy, improve, and sell real estate is organized for profit within the meaning of the statute and is not exempt from tax as a civic league or organization, even though it no longer exercises such powers for profit and is operated exclusively for the promotion of social welfare. (Art. 519.)

Social clubs.—

Law. Section 231. . . . . (9) **Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member; . . . .**

Regulation. The exemption applies to practically all social and recreation clubs which are supported by membership fees, dues, and assessments. If a club, by reason of the comprehensive powers granted in its charter, engages in traffic, in agriculture or horticulture, or in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes, and any profit realized from such activities is subject to tax. (Art. 520.)

Rulings. A provision in the by-laws of a country club, that, in the event of the dissolution of the club, the holder of a life membership shall participate in the distribution of the assets of the club after its other debts are paid and before any sums are paid to either regular members or shareholders, is not alone sufficient to make the club liable to render income tax returns. (C. B. 1, page 202; S. 958.)

A club formed for the purpose of providing for the members thereof a suitable meeting place, a library, and a dining room, where meals will be furnished to the members, the income being derived from membership dues and the receipts for food, wine, and cigars purchased by members, and no part of the net earnings inuring to the private benefit of any member, is entitled to exemption from taxation and will not be required to file returns of annual net income. (C. B. 1, 203; O. D. 108.)

Mutual insurance companies, etc.—Included under this caption are mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, and mutual or co-operative telephone companies. For law and regulations, see Chapter XXXVIII, "Insurance Companies."

Co-operative associations, etc.—

Law. Section 231. . . . . (11) **Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses; . . . .**

The second half of subsection (11) which refers to purchasing operations, is a new provision of the 1921 law.

REGULATION. (*a*) Cooperative associations, acting as sales agents for farmers, fruit growers, dairymen, etc., and turning back to them the proceeds of the sales, less the necessary selling expenses, on the basis of the produce furnished by them, are exempt from income tax. Thus cooperative dairy companies, which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among their members upon the basis of the quantity of milk or of butter fat in the milk furnished by such members, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, or if the association deducts more than necessary selling expenses, it does not meet the requirements of the statute and is not exempt. The maintenance of a reasonable reserve for depreciation or possible losses or a reserve required by State statute will not necessarily destroy the exemption. A corporation organized to act as a sales agent for farmers and having a capital stock on which it pays a fixed dividend amounting to the legal rate of interest, all of the capital stock being owned by such farmers, will not for that reason be denied exemption.

(*b*) Cooperative associations organized and operated as purchasing agents for farmers, fruit growers, dairymen, etc., for the purpose of buying supplies and equipment for the use of members and turning over such supplies and equipment to members at actual cost, plus necessary expenses, are also exempt. In order to be exempt under either (*a*) or (*b*) an association must establish that it has no net income from its own account. An association acting both as a sales and a purchasing agent is exempt if as to each of its functions it meets the requirements of the statute. (Art. 522.)

This article now permits a sales organization to be incorporated and to pay a fixed dividend on its capital stock without forfeiting its right to exemption. A purchasing agency is now entitled to exemption.

RULINGS. An incorporated fruit growers' union which conducts its business at a profit, thereby accumulating a fund out of which dividends are paid, is deprived of exemption from tax if it allows persons who are not fruit growers to acquire stock and thus share in the profits. To the extent that it has such stockholders it loses its character as sales agent acting for the mutual benefit of the fruit growers, and accordingly its exemption from tax also. The union may, however, deduct from gross income amounts periodically returned to members as a refund of profits on business transacted with

them, and proportioned to the amount of such business. (C. B. 1, page 208; O. D. 64.)

A cooperative store managed by a university for the purpose of selling to its students supplies of every kind, and in case of dissolution its property reverting to the trustees of the school, does not come within the class of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof. It is actively engaged in the operation of a business in which profits are realized and will, therefore, be required to file returns of annual net income and to pay any tax thereby shown to be due. (C. B. 1, page 208; O. D. 65.)

It is hardly possible that any actual profit would accrue to a university store. Before paying tax on an apparent profit from such a project as that described in the last ruling, a university should make sure that all proper charges, such as rent for quarters furnished the store, etc., are deducted.

Ruling. A cooperative apartment-owning corporation, which derives its income from collecting the expense of operating the apartments each month from its members, each of whom is entitled to occupy an apartment in the building, is not exempt from taxation. (B. Digest, 38-21-1832; O. D. 1042.)

Corporations serving exempt corporations.—

Law. Section 231. . . . . **(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;[14] . . . .**

Federal land banks.—

Law. Section 231. . . . . **(13) Federal land banks and national farm-loan associations as provided in section 26 of the act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes"; . . . .**

Personal service corporations.—

Law. Section 231. . . . . **(14) Personal service corpora-**

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[14] **[Former Procedure]** Such corporations were taxable under the 1913 law, T. D. 2137 (January 30, 1915).

tions.[15] This subdivision shall not be in effect after December 31, 1921.

Corporations of this type were first distinguished from corporations in general in the 1918 law, which defined them as follows:

1918 LAW. Section 200. . . . . **The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; . . . .**

This definition has been re-enacted into the 1921 law.

For regulations and procedure, see Chapter XXIV.

Establishing a right to exemption.—A corporation is not exempt from the tax merely because it is not organized and operated primarily for profit. If it does not come within one of the fourteen classes enumerated above, it is taxable even though the purpose of the corporation may not be to operate for the profit of its members or stockholders.

Not all of the corporations mentioned in the above classes are unconditionally exempt. In all cases in which a condition is inserted, such as to the effect that no part of the net earnings shall inure to the benefit of any private stockholder, the right to exemption must be demonstrated in accordance with the following regulation:

REGULATION. In order to establish its exemption, and thus be relieved of the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption, except personal service corporations, file an affidavit with the collector of the district in which it is located, showing the character of the organization, the purpose for which it was organized, the sources of its income and its disposition, whether or not any of its income is credited to surplus or may inure to the benefit of any private stockholder or individual, and in general all facts relating to its operations which affect its right to exemption. To such affidavit should be attached

[15] **[Former Procedure]** As the 14th type of exempt corporation the 1916 law gave the following: "Joint-stock land bank, as to income derived from bonds or debentures of other joint-stock land banks or any federal land bank belonging to such joint-stock land bank."

a copy of the charter or articles of incorporation and by-laws of the organization, upon receipt of the affidavit and other papers by the Collector, he will inform the organization whether or not it is exempt. If, however, the collector is in doubt as to the taxable status of the organization, he will refer the affidavit and accompanying papers to the Commissioner for decision. When an organization has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created. Collectors will keep a list of all exempt corporations, to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated. Personal service corporations are not exempt after December 31, 1921; see section 218 of the statute and articles 336-339. (Art. 511.)

The new article inserts the statement that the exemption of personal service corporations expires December 31, 1921, as a result of the change in status of these corporations after that date. It also provides that the Commissioner, not the collector, will decide whether corporations are exempt.

Ruling. An organization which would otherwise be exempt from taxation but which operates in a nonexempt manner is not entitled to exemption under the provisions of section 231 of the Revenue Act of 1918; and furthermore, an organization which is ordinarily exempt but which owns property in excess of its needs and carries on industrial pursuits distinct from its exempt activities is not exempt from taxation. (C. B. 4, page 261; O. D. 953.)

If there is any doubt concerning the status of a corporation under the law, it should file a return (in blank, if desired) and attach thereto a statement setting forth fully the facts mentioned above. This will enable it to avoid the imposition of penalties should the Treasury later hold it to be taxable.

Section 231 is applicable to both foreign and domestic corporations alike, except that foreign building and loan associations and co-operative banks are not exempt. If doubt exists as to whether a foreign corporation comes within the classes of exempt organizations enumerated, an affidavit showing all the material facts must be presented to the Treasury, which will then examine the claim and determine its status.

RULING. In dealing with cases coming under section 231, the character of the corporation must be judged by its articles of incorporation, constitution, and by-laws rather than by the declarations of its officers or the method by which it conducts or has conducted its business. Accordingly, if the activities of a company are confined to cooperative selling for the benefit of its patrons, but it is granted additional powers by its charter, it will nevertheless be required to file returns and pay the tax if any is shown to be due. (C. B. 1, page 194; O. D. 190.)

The foregoing ruling may operate to defeat the purpose of the law. The law exempts "organizations" and contains no requirements as to by-laws, etc. An organization which is entitled to exemption on meritorious grounds will get it even though its by-laws are improperly drawn.

The following summary of a recent case illustrates the attitude taken by the courts in deciding doubtful questions:[16]

Exemption of a building owned and used by a church for missionary work was contested as not being a "purely public charity" within the meaning of the Pennsylvania constitution. The court sustained the exemption, holding that such a charity was not necessarily one solely controlled by the state as claimed but extended to a private charitable institution not administered for individual gain; that the true test was the character of the objects sought to be attained.

Exempt corporations must withhold taxes and furnish information.—A corporation exempt as to its income is not thereby exempt from "the witholding requirements[17] nor from furnishing information in accordance with the provisions of the Act[18] . . . ."

While under the law only such corporations as are subject to the tax imposed are specifically required to make annual returns of net income, the Treasury under the law may require such returns. It is not an unreasonable requirement.

Salaries paid by an exempt corporation are, of course, taxable to the recipient.[19]

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[16] *Board of Home Missions v. City of Philadelphia,* 109 Atl. 664; 266 Pa. 405.

[17] See Chapter XI.

[18] See Chapter X.

[19] Section 213.

Holding companies exempt on certain dividends received.—The provision of the law which permits corporations to deduct dividends received from other corporations [section 234 (a-6)] operate to exempt the income of the "not doing business" type of holding company from this source.[20] This, of course, is not an express exemption of that type of corporation. Practically it amounts to this, however, in the case of a holding company which receives no income except dividends from other companies. Even though it has no taxable income a holding company must make a return.

Income of states from public utilities.—In addition to exempt corporations, there is another "exemption of the person" which should be considered in this chapter. Since the federal government possesses no power to tax income which accrues to states or political subdivisions thereof, the income received by such states from public utilities or from the exercise of governmental functions is not taxable.

LAW. Section 213. **That . . . . the term "gross income"— . . . .**

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the Government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon

[19] **[Former Procedure]** The societies for the prevention of cruelty were held to be exempt (*Butterick Co. v. U. S.*, 240 Fed. 539; appeal dismissed, 248 U. S. 587; 63 L. Ed. 434; 39 Sup. Ct. 5). Under the 1913, 1916, and 1917 laws, holding companies are held to be taxable. (*Boston Terminal Co. v. Gill*, 246 Fed. 664; 158 C. C. A. 620.)

such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract; . . . .

REGULATION. Income derived from any public utility or the exercise of any essential governmental function and accruing to any State or Territory of the United States, or to any political subdivision thereof, or to the District of Columbia, or income accruing to the Government of any possession of the United States, or any political subdivision thereof, is exempt from tax. See art. 74. The income of State workmen's compensation insurance funds established by State statutes is not taxable. In the case of a public utility acquired, constructed, operated, or maintained by a taxpayer under contract with any State, Territory, or political subdivision thereof, or with the District of Columbia, containing an agreement that a portion of the net earnings of such public utility shall be paid to the State, Territory, or political subdivision thereof, or the District of Columbia, the amount so paid may be deducted by the taxpayer as a necessary expense in transacting business. (See sec. 214 (a) (1) of the statute. (Art. 87.)

The intent of the Act, in so far as corporations are concerned, is apparently to permit a corporation, in which a state or local government has a part interest, to deduct the amount of income paid to the state or local government, and to require the tax to be paid only upon the portion which accrues to the corporation or its stockholders or to private persons.

The fact that a public utility may be under contract with any state, territory, or political subdivision thereof, does not imply that salaries and wages paid to officers and employees of such public utility are exempt from taxation.[21]

[21] See Chapter XIV.

CHAPTER III

RETURNS—WHEN AND HOW TO MAKE THEM

The income tax law imposes upon taxpayers the duty of "self-assessment," but Congress empowers the Commissioner of Internal Revenue to require detailed returns so that there may be a check on the taxpayers' methods of computation.

Generally speaking, a "return" may be defined as a statement of taxable net income or of information.

Who shall make returns?—A return shall be made by every individual having a net income of

1. $1,000 or more if single, or if married and not living with husband or wife;[1]
2. $2,000 or more if married and living with husband or wife.
3. $1,000 or more if the head of a family, even though in some cases no tax may be due, and
4. $1,000 or more ($2,000 if married) if a minor and not dependent on the parent.

Also, every individual having a *gross* income for the taxable year of $5,000 or over, *regardless of the amount of his net income,* must file a return.[2] By a specific provision, a return is required if the aggregate gross income of husband and wife is $5,000 or over. These requirements are new and will enable the Treasury to scrutinize the deductions which result in reducing a gross income of over $5,000, below $1,000 or $2,000, as the case may be, in which cases no return was heretofore required.

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[1] For cases of changes in marital status, see Chapter XII. Fiduciaries must make returns for individuals, trusts or estates for which they act. See Chapter XXXVII. For returns of non-resident aliens, see Chapter XXXVI.

[2] **[Former Procedure]** Before 1921, *net* income was the sole basis for individual returns. If there was no taxable net income, no return was required.

Every partnership and corporation[3] (not specifically exempt),[4] no matter if it has no net income, is required to file an annual income tax return. Partnerships are not themselves taxable upon the net income so reported, but the returns must nevertheless be made.[5] Personal service corporations, for the calendar year 1921 only, are not taxable as such but must make returns.[6] From January 1, 1922, personal service corporations are taxed as ordinary corporations, except that no provision seems to have been made for the imposition of the capital stock tax until July 1, 1922.

In addition to these statements of total net income received, there are various other returns to be made under the income tax law which give to the Treasury information considered essential to proper administration. The more important of the various types of returns are considered individually later.[7]

Commissioner may require any returns "necessary."—In addition to making specific provisions for certain returns, the law grants to the Commissioner the broad and inclusive power to require any returns which he may consider necessary. The authority is given in the following sections:

LAW. Section 1300. **That . . . . every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall**

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[3] The term "corporation" includes associations, joint-stock companies, and insurance companies (section 1). Corporations must, of course, file excess profits tax returns. Both income and profits tax returns are now made in one return.

[4] The law (section 239) states the requirement positively rather than negatively. Exempt corporations must establish their right to exemption. (See Chapter II.)

[5] **[Former Procedure]** Before 1918 no income tax returns were required from partnerships except upon call from the Commissioner. Excess profits tax returns were required under 1917 law.

[6] For a definition of personal service corporation, see Chapter XXIV.

[7] Detailed illustrations of returns under the 1918 law for individuals appear in the Appendix of *Income Tax Procedure*, 1920; for corporations in the Appendix of *Excess Profits Tax Procedure*, 1921.

Illustrations of returns covering special features under the 1921 law, for individuals, appear in Chapter VII, and for corporations in Chapter V of the excess profits tax section (Appendix A) of this volume.

comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

LAW. Section 1307. That whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

LAW. Section 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act. . . .

The Treasury requires various special returns which give details regarding complicated calculations, such as those involved in ascertaining depletion allowances and income from the appreciation of property values.[8]

Time for filing returns.[9]—Returns are due two months and fifteen days after the close of the taxable year, except in the case of non-resident aliens, for whom see Chapter XXXVI. The following section of the law applies to the annual returns of both individuals and corporations.[10]

LAW. Section 227. (a) That returns (except in the case of non-resident aliens)[11] shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March.[12] . . . .

"LAST DUE DATE."—

REGULATION. The last due date is the last day upon which a return is required to be filed in accordance with the provisions of the

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[8] Form O revised, (oil and gas) form D (minerals), form E (coal), form F (non-metals), form T (timber).

[9] For extension of time, see page 55.

[10] For corporations, see section 241 (a).

[11] Non-resident alien individual returns under the 1921 law need not be filed until the fifteenth day of the *sixth* month following the close of the year (see Chapter XXXVI).

[12] [Former Procedure] The laws prior to 1918 made March 1 the date for filing returns, except for taxpayers reporting on the basis of fiscal years. In such cases the return was due sixty days after the close of the fiscal year [1913 law, section G (c); 1916 and 1917 laws, section 13 (b)]. To cover the case of individuals who desired to change from a calendar to a fiscal year under the power granted by the 1918 law, the regulations (Art. 441) provided that returns for fiscal years ending during 1918 might be made "on or before the fifteenth day of March, 1919."

statute or the last day of the period covered by an extension of time granted by the collector or Commissioner. When the last due date falls on Sunday or a legal holiday, the last due date for filing returns will be the day following such Sunday or legal holiday. . . . . (Art. 446, Reg. 45, Art. 447.)

FILING DATE IN CASES OF LIQUIDATION.—A concern which goes into liquidation may file a return before the expiration of its taxable year.

REGULATION. . . . . A corporation going into liquidation during any taxable year may upon the completion of such liquidation prepare a return covering its income for the fractional part of the year during which it was engaged in business and may immediately file such return with the collector. . . . . (Art. 651.)

Although a liquidating corporation may be a subsidiary of a holding company, the regulations permit the filing of a return immediately after liquidation; but if for the purposes of a consolidated return the holding company desired to withhold the return until the end of its fiscal year, it could do so. The regulation is permissive, not mandatory.

If a return is made for a portion of a taxable year, the exemptions and invested capital must be reduced.[13] Since this results in a great tax it is advantageous to wait until the close of the year.

A corporation which is dissolved before the close of its taxable year has the same time in which to file its final return as if it had continued in existence during its entire taxable year.[14]

Extensions of time for filing returns.—In the case of both individuals and corporations:

LAW. Section 227. (a) . . . . The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who

[13] *Excess Profits Tax Procedure,* 1921, pages 110, 259.

[14] C. B. 4, page 277; O. D. 692.

are abroad, no such extension shall be for more than six months.[15] . . . .

This authorization is, of course, broad enough to permit general extensions as well as extensions in the cases of particular taxpayers. Authority has been delegated to the local collectors of internal revenue to make an extension of thirty days only in case of sickness or absence. Power to grant other extensions rests with the Commissioner.[16]

EXTENSION OF TIME FOR JOINT RETURN.—

RULING. Where a husband and wife file a joint return and an extension of time has been granted to either of them, the benefit of the extension inures to both and it will be unnecessary for the other party to secure additional authority. (C. B. 2, page 203; O. D. 521.)

APPLICATION TO THE COLLECTOR FOR THIRTY-DAY EXTENSION IN CASE OF ABSENCE OR SICKNESS.—In case an extension of not more than thirty days is desired because of absence or sickness, application should be made by letter to the local collector with whom the return is to be filed.

LAW. Section 1311. [Section 3176, Rev. Stat.] . . . . **If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper. . . . .**

From the above section of the law, it clearly appears that application may be made *after* the expiration of the period in which the return is normally required to be filed; but the application for such extension must not be delayed beyond the period (thirty days) for which the extension is desired. The conditions which govern extensions of time in cases of individuals and corporations are fully set forth in the following regulation:

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[15] **[Former Procedure]** Under the 1913 law (section 3176) the Commissioner was authorized to grant extensions only in case of sickness or absence and even then was limited to thirty days. The 1916 law [section 14 (c)] introduced this provision: "That the Commissioner of Internal Revenue shall have authority, in the case of either corporations or individuals, to grant a reasonable extension of time, in meritorious cases as he may deem proper." The six months' limitation was first introduced in the 1918 law.

[16] See page 58.

REGULATION. It is important that the taxpayer render before the return due date a return as complete and final as it is possible for him to prepare. However, in cases of sickness or absence, collectors are authorized to grant an extension of not exceeding 30 days, where in their judgment such further time is actually required for the making of an accurate return. See article 1002. The application for such extension must be made prior to the due date of the return. The absence or sickness of one or more officers of a corporation at the time the return is required to be filed will not be accepted as a reasonable cause for failure to file the return within the prescribed time, unless it is satisfactorily shown that there were no other principal officers available and sufficiently informed as to the affairs of the corporation to make and verify the return. As a condition of granting an extension of time for filing a return the collector may require the submission of a tentative return and estimate of the tax and the payment of one-fourth of the estimated amount of tax. A tentative return should be made on the usual return form, plainly marked "tentative" at the top, contain a statement as to the estimated amount of tax believed to be due, and be properly executed. No other data need be given. Tentative returns will not be accepted unless permission is obtained previous to filing. A copy of the authority for filing the tenative return must be attached thereto when filed. Where a taxpayer has filed a tentative return and has failed to file a complete return within the period of the extension requested by him, the complete return when filed is subject to penalties prescribed for delinquency. Where a tentative return has been filed and no time has been fixed within which a complete return must be filed, the collector may at any time send notice to the taxpayer to file a complete return within a period of time therein specified by him, and a taxpayer who fails to comply with such request will incur the penalties prescribed by statute for delinquency in filing a return. As to interest see article 1003. Collectors should not grant extensions of time for filing Forms 1096 and 1099. Requests for such extensions should be made to the Commissioner. (Art. 443.)

The new article requires applications to collectors for extensions, in cases of absence or sickness, to be made *prior* to the due date of the returns. The former procedure was to apply for the extension within thirty days *after* the due date of the return. Forms 1040-T (individuals) and 1031-T (partnerships) are no longer to be used for tentative returns; the ordinary forms plainly marked "tentative" are to be used. A tentative return will not be accepted unless previous permission to file such a return has been given.

Applications to Commissioner for other extensions.—Local collectors are not authorized to grant extensions of more than thirty days or in cases other than those of sickness or absence.[17] The circumstances under which the Commissioner may grant a limited further extension are set forth in the following regulation.

Regulation. If before the end of an extension of thirty days granted by the collector an accurate return can not be made, an appeal for a further extension must be made to the Commissioner with a full recital of the causes for the delay. The Commissioner will not grant an additional extension without a clear showing that a complete return can not be made at the end of the thirty day period. The Commissioner will grant no such extension beyond the original due date of the third installment of the tax. Either a complete or a tentative return, as complete as possible and giving a ground for assessment of the tax, must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the return. If a complete return can not be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted. In exceptional circumstances the taxpayer may apply originally to the Commissioner for an extension of time. . . . . (Art. 444.)

Extension of time for filing returns due March 15, 1922.[18]—Under the law collectors may grant extensions of thirty days in case of sickness or absence. The Commissioner grants extensions up to six months "whenever in his judgment good cause exists." In view of the many and complicated problems involved, it has become increasingly difficult for individuals and corporations to prepare their returns by March 15, even when the law remains unchanged. The 1921 law was

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[17] See page 56.

[18] Corporations were granted an extension to May 15, 1920, for filing the 1919 returns. Tentative returns had to be filed by March 15 on form 1120, on which was written "Tentative Return." It was only necessary to show the estimated amount of tax due. The return, of course, had to be accompanied by one-fourth of the estimated tax, together with a statement setting forth the reason why the return could not be completed within the prescribed time and a formal request for the extension.

In the statement granting this extension, the Commissioner stated that no further extension would be granted except in extraordinary cases. (I. T. M. 2420, dated March 4, 1920.)

There was no general extension of time in 1921 but individual extensions were granted in all meritorious cases.

not passed until November 23, 1921. It will not be possible for taxpayers to secure authoritative interpretations of the law and adjust their accounts before March 15, 1922. It is possible, however, to submit tentative returns which contain merely an estimate of the amount of tax due. Since the government can require that at least 25 per cent of the estimate be paid on or before March 15, and since in no event is any audit made of the returns until a year or more later, it may be expected that the Commissioner will freely accept tentative returns on March 15, 1922, and require final returns by, say, May 15. There are corporations with ramifications extending the world over which have never before or since the existence of the federal income tax laws been able to close their books within a 75-day period. The Treasury has not dealt harshly with this class of taxpayers. It does, however, very properly require that, when additional time is required, it shall be asked for in due season and that sound reasons shall be given for the request.

When taxpayers live abroad.—Section 227 (a) of the law provides that the six months' limitation shall not cover the case of taxpayers who are abroad. American citizens residing abroad, who, because of war conditions or of absence from the country, have not been able to file their returns for past years, may take advantage of this provision, which operates generally and without request by the taxpayer. The details concerning extensions in such cases appear in the following regulation:

Regulation. Where a delinquent return is filed by or on behalf of a person who is abroad, an affidavit must be attached to the return, stating the cause of the delay in filing it, in order that the commissioner may determine whether the failure to file the return in time was due to a reasonable cause and whether the return was filed without any unnecessary delay. If the showing justifies the conclusion that the failure to file the return in time was excusable, no penalty will be imposed. The installments of tax which are actually due must be paid at the time of filing the return, and the other installments shall be paid as they fall due. In case an extension is granted, interest is

payable at the rate of one-half of 1 per cent per month from the time the tax would have been due if no extension had been granted. (Art. 445.)

The extension granted under the old regulation was to allow for the disturbed conditions arising from the war, but the new article is apparently applicable in any case where a taxpayer is abroad and, in consequence, is unable to file his return.

The Treasury held[19] that the old article 445 applied to domestic corporations which transacted their business and kept their books of account abroad. There appears to be no reason why a similar interpretation should not be applied to the new article.

EXTENSION OF TIME FOR NON-RESIDENT ENEMIES.—

REGULATION. An extension of time is hereby granted for such period as may be necessary, not exceeding ninety days after proclamation by the President of the end of the war with Germany, for filing returns of income for 1918 and subsequent years and for paying the tax by or for nonresident enemies or allies of enemies, as defined by section 2 of the Trading with the Enemy Act of October 6, 1917, not holding licenses granted under the provisions of that act. The whole tax shown to be due must be paid at the time of filing the return. This extension, however, does not authorize any delay in filing returns of information. This extension is also subject to the condition that all persons who on October 6, 1917, had or since have had or may hereafter have control of any money or other property for any such enemy or ally of enemy, or who on October 6, 1917, were or since have been or may hereafter be indebted to any such enemy or ally of enemy, shall hold and deliver all said money and property in all respects subject to the Trading with the Enemy Act and to the orders of the President and of the alien property custodian thereunder, and shall in due course file returns of income in respect of all such money and property for such period as may elapse or have elapsed prior to the actual delivery of such money and property to the alien property custodian. . . . . (Reg. 45, Art. 446.)

This article does not appear in the new regulations. It is included here as returns under it may be made until February 12, 1922.

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[19] C. B. 2, page 203; O. D. 443.

"TERMINATION OF THE WAR"—WHEN NINETY DAY PERIOD BEGINS TO RUN.—The Joint Resolution of Congress,[20] approved by the President March 3, 1921, declared: "That in the interpretation of any provision relating to the duration or date of the termination of the present war . . . . the date when the resolution becomes effective shall be construed and treated as the date of the termination of the war . . ."

The war was terminated by Joint Resolution of Congress, approved by the President July 2, 1921. The proclamation of the President, declaring the war terminated as at July 2, 1921, was issued on November 14, 1921.

For purposes of amortization[21] the Treasury has held that the war terminated on March 3, 1921.

The Treasury holds that the ninety-day extension for filing returns in case of taxpayers abroad dates from November 14, 1921. The President's proclamation of November 14, 1921, fixes July 2, 1921, as the date of the termination of the war. However, it can hardly be contended that the ninety-day period runs from July 2, 1921, since the latest date for filing returns under such an assumption would have passed before the proclamation was signed by the President and those concerned were thereby notified.

RULING. Receipt is acknowledged of your letter of March 11, 1921, requesting to be advised whether the joint resolution relating to the termination of the war for certain purposes passed by Congress and approved by the President on March 3, 1921, is construed by this office to set running the period of ninety days after the termination of the war granted to nonresident enemies for filing income tax returns for 1918 and subsequent years under the provisions of Article 446 of Regulations 45. . . . .

Article 446 of Regulations 45 is based upon the authority vested in the Commissioner by Section 227 of the Revenue Act of 1918 to grant reasonable extensions of time for filing returns whenever in his judgment good cause exists. Since Section 227 does not relate to the duration or date of termination of the present war with Germany and Austro-Hungary, it does not fall within the purview of the Joint Resolution approved March 3, 1921. The ninety days men-

[20] Public No. 64—66th Congress.
[21] See Chapter XXXII.

tioned in Article 446 will become effective from the date of the termination of the war with Germany when such date has been established by the President through a proclamation. Article 446 is still in effect and will remain in effect, until revoked either by operation of its own terms, operation of law, or the action of this office. The Joint Resolution approved March 3, 1921, therefore, did not affect the provisions of Article 446 of Regulations 45. (Letter signed by Commissioner Wm. M. Williams, dated April 7, 1921.)

RULING. Receipt is acknowledged of your letter of May 23, 1921, in which you inquire whether office letter of April 7, 1921, is not in conflict with the opinion of the Solicitor sent you under date of March 22, 1921, in answer to your question as to when the present war was terminated for amortization purposes.

In the opinion of the Solicitor, it was held that the termination of the war was March 3, 1921, in view of the Joint Resolution of Congress.

In office letter of March 7, 1921, this office held that Article 446, Regulations 45, did not fall within the purview of the Joint Resolution approved March 3, 1921.

Article 187, Regulations 45, is based on Section 214 (a) of the Revenue Act of 1918, which provides, in part, that "at any time within three years after the termination of the present war, the Commissioner may, and at the request of the taxpayer shall, re-examine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect the taxes imposed by this title and by Title III for the year or years affected shall be redetermined." Article 187 is, therefore, affected by the date of the termination of the present war. Prior to the approval of the Joint Resolution, the date of the termination of the present war, under Section 1 of the Act, was to be determined by proclamation of the President. The Joint Resolution provided, however, that the date when such resolution becomes effective shall be treated as the date of the termination of the war or existing emergency notwithstanding any provision in any Act of Congress.

Article 446, Regulations 45, derives its force and effect from Section 227 (a) of the Revenue Act of 1918, which provides that "the Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months." Since this Section of the Act does not relate to the duration or date of termination of the present war, it was not affected by the Joint Resolution approved March 3, 1921.

There was no conflict, therefore, between the ruling of this office made under date of April 7, 1921, and the opinion of the So-

licitor sent you under date of March 22, 1921. (Letter to Prentice-Hall, Inc., signed by E. H. Batson, dated June 7, 1921.)

The foregoing ruling holds that the Joint Resolutions of Congress (March 3, 1921, and July 2, 1921) are not controlling. Articles 445 and 446, promulgated by the Commissioner, both state that the extension is for a period "not exceeding ninety days after proclamation by the President of the end of the war with Germany." Since the proclamation was not issued until November 14, 1921, there is no doubt but that the ninety-day period begins to run from that date.

Place for filing returns.—In the case of individuals the law prescribes that:

LAW. Section 227. . . . . **(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.**

An individual whose legal residence and principal place of business are not in the same district has the option as to which place he will file his annual return.

In the case of corporations, returns must be filed in the district in which is located the principal place of business of the corporation.

LAW. Section 241. . . . . **(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.**

RETURNS FILED BY MAIL.—Returns may be delivered either by hand or by mail.

REGULATION. . . . . If placed in the mails the return should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office of the collector on or before the last due date, no penalty will attach should the return not be actually received by such

officer until subsequently to that date. Where a question may be raised as to whether or not the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. (Art. 446.)

This article was heretofore numbered 447.

Period for which returns are made.—Returns of net income are ordinarily made for the "taxable year."[22] Only in unusual circumstances are returns made for a shorter period, as where corporations are entering or going out of business, individuals or corporations are changing fiscal years, and in case of administrators who have made final accountings of estates.

"TAXABLE YEAR" AND "FISCAL YEAR" DEFINED.—The terms "taxable year" and "fiscal year" are defined in the law as follows:

LAW. Section 200. . . . . **(1) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1921, shall be the calendar year 1921 or any fiscal year ending during the calendar year 1921; . . . .**

FISCAL YEAR BASIS NOW AVAILABLE TO ALL TAXPAYERS.—By 1917[23] corporations and partnerships had acquired the privilege of reporting on the basis of a fiscal instead of a calendar year. The 1918 law extended the privilege to individuals. The same provision is re-enacted in the 1921 law, which reads:

LAW. Section 212. . . . . **(b) The net income shall be com-**

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[22] Returns may not be made for a period exceeding twelve months (see page 72).

[23] **[Former Procedure]** The 1917 law, section 8 (e) extended to partnerships the fiscal year privilege given in the 1913 and 1916 laws to corporations.

puted upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be)[24] . . . . If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(c) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.[25]

A newly organized business, whether incorporated or not, may establish its fiscal year without securing the approval of the Commissioner.[26] In such a case the first return may or may not be for less than twelve months, depending upon the date of organization and the month selected as the close of its fiscal period.

In order to report on a fiscal year basis it is necessary that the taxpayer keep books of account.[27] This is in accordance with the law, which provides that if a taxpayer "does not keep books, the net income shall be computed on the basis of the calendar year." Since the partnership books are the books of each partner, permission to make his personal returns on a fiscal year basis would doubtless be granted to a partner.

FISCAL YEAR REQUIRED IF ACCOUNTS ARE KEPT ON THAT BASIS.—A taxpayer who has an existing accounting period which is a fiscal year within the meaning of the statute, is required to make his return on the basis of such a taxable year regardless of the former basis of rendering returns.[28]

Recognition of accounting periods as taxable years.—A sharp distinction must be drawn between the procedure which applies in cases which have a fiscal year already established, and cases in which it is desired to change one's accounting

[24] See section 218.
[25] See page 69.
[26] C. B. 2, page 67; O. D. 404.
[27] C. B. 3, page 81; O. D. 696.
[28] See page 64.

period and to have the newly established year accepted as the taxable year.[29]

The 1921 law re-enacts the provisions of the 1918 law and makes it obligatory for all taxpayers, both individuals and corporations, to report on the basis of their accounting periods, whether these end on December 31 or on the last day of any other month of the year. The procedure is discussed in the following paragraph. The case of taxpayers who desire both to establish a new accounting year and to have it recognized for tax purposes is discussed on page 67.

Recognition of existing fiscal year as "taxable" year.—The law provides no formality such as a notice to the collector[30] as a condition of the recognition of a fiscal year already established in the taxpayer's accounts. When any change is made in the taxable year, section 212 (b), quoted on page 65, provides that the net income "with the approval of the Commissioner" shall be computed on the basis of such new accounting period. But it has been ruled that the Commissioner's permission need not be specifically sought if the question is merely one of recognition of an existing status.[31] As will be seen from the following regulation, the fiscal year in such cases becomes established as the taxable year through the mere act of the taxpayer in reporting on that basis. This point is of particular significance to individuals who prior to the passage of the 1918 law kept their accounts on a fiscal year basis.

Regulation. The return of a taxpayer is made and his income computed for his taxable year, which means his fiscal year, or the

[29] Taxpayers making their first returns may do so on the basis of fiscal years if they have established such fiscal years. See page 64.

[30] [**Former Procedure**] Under the 1916 law, section 13 (a), notice was required of the day designated as the closing date of the fiscal year "not less than thirty days prior to the first day of March of the year in which its return would be filed if made on the basis of the calendar year." In the case of a change from a fiscal year to a calendar year, a thirty-day notice was required "prior to March 1 next following the closing date of the established fiscal year." (Reg. 33, 1918, Art. 217.) In the absence of notice fiscal year returns were not acceptable. (*Ibid.*, Art. 203.)

[31] C. B. 4, page 67; A. R. R. 301.

calendar year if he has not established a fiscal year. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. The taxable year 1921 is the calendar year 1921 or any fiscal year ending during the calendar year 1921. See sec. 200 of the statute. A person having no such fiscal year must make return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return on the basis (fiscal or calendar year) upon which he made his return for the taxable year immediately preceding unless, with the approval of the commissioner, he has changed his accounting period. (Art. 25.)

RULING. An individual who is sole proprietor of a business must compute his income from all sources on the same basis, and unless he maintains personal books of account in which his income from all business and other sources is reflected on the basis of a fiscal year he does not have a fiscal year which can be recognized as the basis upon which his return may be made. (C. B. 4, page 71; O. D. 941.)

All taxpayers have been on notice since February, 1919, that, as stated in section 212 (b) of the 1918 law, which is re-enacted in the 1921 law: ". . . . The net income *shall* be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year as the case may be) . . . ." The Commissioner is not given any discretion as to requiring returns on the basis stated. If any taxpayer has been reporting on a calendar year basis when his or its books have been kept on a fiscal year basis, there has been a technical but clear violation of the law which should be adjusted as speedily as possible.

RECOGNITION OF A CHANGED ACCOUNTING PERIOD AS A TAXABLE YEAR.—When taxpayers desire to *change* from one accounting period already established and recognized for tax purposes to some other period, they must give a thirty-day written notice and their reasons for the intended change. It is quite proper that changes of this character should be made subject to the approval of the Commissioner, for taxpayers should not be free to change frequently and arbitrarily from one fiscal

year to another. The application must be made by the taxpayer directly interested or by his duly authorized agent. If the latter makes the application, the authority to act for the taxpayer must be produced.[32]

When is change in fiscal year "established"?—After having secured the permission of the Commissioner to change the basis of his return, a taxpayer may for various reasons wish to continue to report on the basis of the old accounting period. The taxpayer may discover that it is not practicable to prepare his return on this new basis, or he may discover that there are certain conditions which he failed to consider when he applied for a change. If he fails to report on this new basis, will he be subject to penalties?

There appear to be two things required to bring about a change: (1) the approval of the Commissioner must be secured, and (2) the change must actually be made and a return filed on the new basis. The law says that the Commissioner may approve changes in accounting periods, but it does not provide that he may create new accounting periods; therefore penalties cannot be imposed unless a new accounting period has been fully established.

The Treasury has held, however, that if application to make a change is made by the taxpayers and is authorized, the change *must* be made.[33] It is difficult to discover under what provision of the law the Treasury can force a taxpayer to make a change in its accounting period if an intention to change has not been made effective in the taxpayer's books. A taxpayer may apply for authority to change his accounting period with the intention of making such a change if and when the permission is received. In the interval between making the application and receiving the authorization, circumstances may arise which cause the taxpayer to alter his desire to change. There is no provision of the law which can

[32] C. B. 4, page 71; Mim. 2738.
[33] C. B. 4, page 71; Mim. 2738.

force the taxpayer to make the change. An actual change must be made and a return must be filed on the new basis before the taxpayer loses his right to continue the old accounting period.

When a corporation has regularly closed its books on December 31, and also for business reasons on some other date in the year, returns are accepted on a calendar year basis.[34]

CHANGES MADE DURING 1918 OR PRIOR.—If a taxpayer made a change in his accounting period during 1918, the approval of the Commissioner was not necessary. The Revenue Act of 1918 was not approved until February 24, 1919; so any changes made prior to the passage of the law, whether from calendar to fiscal year or vice versa, were confirmed thereby.[35]

FISCAL YEARS FIXED BY STATE LEGISLATURES.—If a state wishes to change the accounting period of public service corporations, it is not necessary for taxpayers to secure the permission of the Commissioner to report on the new basis.[36]

It seems to follow that, if a state wished to fix the fiscal years of all corporations created by that state, which it could no doubt do, such corporations would be obligated to report on this new basis, and it would not be necessary to secure the permission of the Commissioner. The approval of the Commissioner appears to be necessary only when the taxpayer voluntarily changes his fiscal year.

Return when accounting period is changed.—

LAW. Section 226. (a) That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made

[34] C. B. 4, page 69; A. R. R. 501.
[35] C. B. 3, page 81; A. R. R. 342.
[36] C. B. 1, page 62; O. D. 100.

for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year. . . . .

The provision found in the 1918 law[37] to the effect that in the case of a first return on a fiscal year basis a return should be filed for the period between the beginning of the calendar year in which the fiscal year ends and the end of the fiscal year, was not re-enacted in the 1921 law. This provision was ambiguous and unnecessary.

LAW. Section 226. . . . . (b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

(c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.[38]

The foregoing provision places net income on an annual basis and has the effect of subjecting such income to a higher surtax rate than was the case under the former method of computation. The law now subjects the net income to the same high rates as would be the case if income throughout the year

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[37] [Former Procedure]

1918 LAW. Section 226. . . . . If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year. . . . .

[38] [Former Procedure]

1918 LAW. Section 226. . . . . In all of the above cases the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included; and the credits provided in subdivisions (c) and (d) of section 216 shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

The credits which must be prorated [section 216 (c) and (d)] are the $1,000 or $2,000 exemptions and the $200 credits for dependents.

were received at the same rate as during the fractional period. An illustration of the increased tax payable under the new method of computation is given in Chapter VII.

It is not necessary to apply the provisions to corporations in determining the excess profits tax, because the same result is reached by providing for a pro rata reduction of invested capital and the specific exemption of $3,000.[39]

NOTICE TO COMMISSIONER REQUIRED.—

REGULATION. If a taxpayer changes his accounting period he shall as soon as possible give to the collector for transmission to the Commissioner written notice of such change and of his reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given 30 days before the close of the proposed or new taxable year or period. The due date of the separate return for such period is the fifteenth day of the third month following the close of that period. If the change in the basis of computing the net income of the taxpayer is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. . . . . (Art. 26.)

The foregoing regulation changes the date prior to which notice of change of fiscal year must be filed with the collector for transmission to the Commissioner.[40]

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[39] See Chapter VII.

[40] **[Former Procedure]** Since the 1916 law and the 1917 amendments thereto specifically provided that all returns must be made on a calendar year basis, unless a fiscal year was designated according to the provisions of the law, any changes made in the accounting period during 1918 or subsequently cannot affect any returns, calendar or fiscal, made for the year 1917. It also follows that the Commissioner is without power to accept amended returns for the year 1917 on the basis of a changed accounting period.

RULING. "A corporation having kept its accounts on a fiscal year basis, and not having made application for permission to change to a calendar year basis until July 6, 1920, will not be permitted to file its returns on the calendar year basis for the years 1918 and 1919." (C. B. 4, page 67; A. R. R. 391.)

Under Art. 26 of Reg. 45, notice had to be given at a time which was both (a) thirty days before the due date of the taxpayer's return on its existing basis, and (b) thirty days before the due date of the return for the period between the end of his existing taxable year and the end of the proposed taxable year. The Treasury held that in the case of a taxpayer who filed a return for a fiscal year ended June 30, and desired to change to a calendar year basis, notice must be given at least thirty days prior to March 15 of the following year. (C. B. 2, page 67; Sol. Op. 5.)

Change of fiscal year to obtain greater advantage from net loss provision.—Section 204 (b) of the 1921 law provides that if a taxpayer sustains a net loss, it may be deducted from the net income of the next succeeding two years ending after December 31, 1920.[41] Subdivision (d) of the same section provides that in the case of a fiscal year beginning in 1920 and ending in 1921, the taxpayers shall be entitled to the benefits of the net loss provision in proportion to the part of such fiscal year falling in 1921.

It is quite conceivable that a future shifting of fiscal year dates may result in reduced taxes. It may result in increased taxes. The law regarding changes in fiscal periods is clear, so no retroactive shifting is possible. With lower rates of tax and the certainty that tax laws will continue to change, the possibilities of tax-saving by fiscal-year shifting are not worth much thought.

Return must not cover period exceeding twelve months.—Throughout the law reference is made to a taxable year or to a calendar year and to parts of a taxable year, and it is stated that a fiscal year means an accounting period of twelve months.[42] In no case is there a specific prohibition in the law against a return covering a period of more than twelve months; but the direction to file for a year or less would be held to be a prohibition. A regulation specifically prohibits the use of a period of more than twelve months.

REGULATION. No return can be made for a period of more than twelve months. . . . . (Art. 431.)

Blank forms for returns.—Returns must be made in the form prescribed by the Commissioner, with the approval of the Secretary of the Treasury. Blank forms are to be had from collectors. They are mailed without special request to the

[41] **[Former Procedure]** Section 204 (b) of the 1918 law enacted a somewhat similar net loss provision. See *Income Tax Procedure*, 1921, page 783, *et seq.*

[42] Section 200.

taxpayers on the records, but failure to receive a form does not excuse the taxpayer from reporting in due season. If the form is not received in ample time to prepare and file it on or before the due date, usually March 15, application for a copy should be made to the office of the local collector of internal revenue or to any bank or post-office. Taxpayers should retain exact copies of returns as filed. The forms to be used in 1922 for individual returns of $5,000 and over include a duplicate sheet as an integral part of the return. This duplicate will obviate the necessity of securing an extra copy of the form. In the case of forms which do not include duplicate sheets, taxpayers should secure extra copies of the blanks and retain exact duplicates of all returns filed. When not obtainable from collectors application for them should be made direct to the Commissioner in Washington.

REGULATION. Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. Failure on the part of any taxpayer to receive a blank form will not, however, excuse him from making a return. . . . . In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form. . . . . (Art. 407.)

FORMS FOR 1922.—Form 1040 will be used in 1922 by individuals whose net income exceeds $5,000; for the separate returns of husband and wife when the combined net incomes exceed $5,000; for returns covering less than a year when the net income placed on an annual basis exceeds $5,000; when the individual's net income exceeds $4,000 and the entire family exemption is taken in a separate return filed by husband or wife.

Form 1040A, with the exceptions noted above, will be used in cases where the net income of individual taxpayers is less than $5,000.

Copies of forms 1040A and 1040 appear in Appendix B.

Form 1041 will be used for filing returns of fiduciaries,[43] form 1065 for partnerships and personal service corporations, and form 1120 for corporations.

It has been suggested to the Treasury that it would be a great improvement if returns such as those required from corporations were prepared on forms not over 8½ x 11 inches in size, using as many sheets as necessary.

[43] See Chapter XXXVII for the use of other forms by fiduciaries.

CHAPTER IV

RETURNS OF INDIVIDUALS AND CORPORATIONS

The preceding chapter explained the law and regulations as to who must make returns, the time for filing returns, and other such requirements. The specific procedure to be followed by individuals and corporations now follows.[1]

Annual Returns by Individuals

Who shall make returns.—

LAW. Section 223. (a) That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title.—[2]

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife; and

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income. . . . .

The 1921 law for the first time requires a return to be filed whenever the gross income of an individual is $5,000 or over.

A taxpayer with a gross income of $7,000, and allowable deductions of $5,100 (leaving net income of $1,900) would, under the 1918 law, if he were married, make no return, since his net income is under $2,000. Under the 1921 law, however, it is necessary to file a complete return even though no tax is payable.

REGULATION. . . . . Whether or not an individual is the head of a family[3] or has dependents is immaterial in determining his liability

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[1] Returns of partnerships and personal service corporations are fully discussed in Chapter XXIV.

[2] See page 52.

[3] For definition of "head of a family," see Chapter XII.

to render a return. If an individual is a married person living with husband or wife, no return need be made unless their aggregate gross income is at least $5,000 or their aggregate net income is at least $2,000; but a separate return must be made by each of them, regardless of the amount of the individual income of each, where their aggregate gross income is $5,000 or over, or their aggregate net income is $2,000 or over, unless they join in a single joint return. Where the income of each is included in a single joint return, the tax is computed on the aggregate income and all deductions and credits to which either is entitled shall be taken from such aggregate income. The husband shall include in his return the income derived from services rendered by the wife or from the sale of products of her labor if she does not file a separate return or join with him in a return setting forth her income separately. . . . . (Art. 401.)

This article has been amended to take cognizance of the fact that a gross income of $5,000 is a determining factor in filing returns.

It should be noted that the terms "net income" and "gross income" are used, which means that dividends, exemptions for dependents, and other "credits" may not be deducted from the amount which determines whether or not a return is to be made.[4] Thus there are undoubtedly many individuals who are required to make returns who, after they have applied all their "credits,"[5] will have no tax to pay.

Taxpayers whose entire net income is derived from interest on tax-exempt securities enumerated in section 213 (b-4) are relieved, under the 1921 law, from the necessity of making any return. They do not come under the provision of section 223 (a-3) requiring a return where the gross income is $5,000 or over, because such tax-exempt interest is expressly excluded from gross income. In fact, all taxpayers are relieved from reporting income from tax-exempt securities.[6]

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[4] See Chapter XII.

[5] Section 216.

[6] In the Senate bill the proviso in section 213 of the 1918 law calling for the return of such income was eliminated, but an amendment to section 258 was inserted, reading in part:

"In connection with every return is to be submitted a statement showing holdings of all tax free securities, including all Government bonds, notes, etc., and the income received therefrom. Penalty for failure to comply,

It is apparent, also, that the only individual who can take advantage of the permission to refrain from reporting when his net income exceeds $1,000 but is less than $2,000 (and whose gross income together with that of his wife is less than $5,000) is one who is "married and living with husband or wife." Heads of families who are unmarried[7] must report when they have net incomes in excess of $1,000 even though, because of dependents, they may have "credits" enough to cancel all their income above that amount.

Return may be filed by agents—when.—

LAW. Section 223. . . . . **If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.**

In the case of a personal return, "the affidavit must be executed by the person whose income is reported unless he is a minor or incompetent or unless he is ill, absent from the country or otherwise incapacitated, in which case the legal representative or agent may execute the affidavit."[8]

REGULATION. There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. A fiduciary relationship can not be created by a power of attorney. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the statute. In cases where no legal trust has been created in the estate controlled by the agent and attorney the liability to make a return rests with the principal. (Art. 1522.)

Fiduciaries use form 1041. An agent uses the form

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in addition to all other penalties provided by law, is 5% of amount of tax (if any)."

The requirement was, however, eliminated in the 1921 law as finally enacted.

[7] See Chapter XII.

[8] Form 1040A (1922), instructions.

(usually form 1040) which his principal would file if able to do so in person.

REGULATION. . . . . The return may be made by an agent when by reason of illness, absence, or nonresidence the person liable for the return is unable to make it, the agent assuming the responsibility for making the return and incurring liability to the specific penalties provided for erroneous, false, or fraudulent returns. . . . . (Art. 402.)

Return must be under oath.—The law requires that "every person liable to any tax imposed by this Act, or for the collection thereof, shall . . . . render, under oath, such statements and returns . . . . as the Commissioner, with the approval of the Secretary, may from time to time prescribe."[9]

The following regulation gives instructions for executing an affidavit:

REGULATION. All income tax returns must be verified under oath or affirmation before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the State or Territory where such officer resides. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those services. Income tax returns executed abroad may be attested free of charge before United States consular officers. Where a foreign notary or other official having no seal shall act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer. (Art. 406.)

The Treasury has held that oaths should be administered by officers having general rather than specific authority. Postmasters, it was held, cannot therefore properly administer oaths for income tax purposes.[10]

Separate returns of husband and wife—when desirable.—

LAW. Section 223. . . . . (b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over—

(1) Each shall make such a return, or

(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income. . . . .

[9] Section 1300. For verification of corporation returns, see Chapter VII.

[10] C. B. [illegible] page [illegible]8; O. D. 701.

Under the foregoing provision of the 1921 law, the requirement that a return must be filed where the gross income is $5,000 or over, is made to apply to the *aggregate gross income of husband and wife,* when they are living together.

If husband and wife are not living together, and if the net income of either is $1,000 or more, separate returns must be made.

If husband and wife, living together, elect to make a single joint return, the tax then "shall be computed on the aggregate income." This provision of the 1921 law is new. The privilege of applying one spouse's loss or deductions against the other's income, however, may be availed of in the making of a single joint return.

If husband and wife heretofore have filed separate returns, nevertheless in 1921 or any future year they may file a joint return.

RULINGS. A husband and wife may elect to file a joint return one year and separate returns the next, regardless of whether such election results in a benefit to them or a benefit to the Government. (B. 27-21-1715; O. D. 968.)

Where husband and wife clearly indicate on a single return form the net income of each and compute the tax on the basis of such separate income, the return so filed does not constitute a joint return, but the separate return of each individual. Where, however, a single return form is used clearly indicating the separate net income of husband and wife but the tax is computed upon the basis of combined income, such return is a joint return. (C. B. 4, page 255; O. D. 960.)

In practically every case where a husband and a wife have a substantial income, separate returns should be filed in order that the surtax may be applied separately. It is not necessary to file separate returns to secure the benefit of the calculation if the taxpayer is careful to segregate the income and deductions of each. Usually it is better to file separate returns.[11]

In case husband and wife each received an independent

[11] [Former Procedure] The Treasury has not always assessed the surtax separately, but has in some cases levied and collected an excessive tax which would not have been imposed if separate returns had been made.

net income equal to or in excess of $1,000, separate returns may be made, but a joint return will ordinarily serve unless the combined net income exceeds $5,000. Below that figure the taxes would, with two exceptions, be the same even though the incomes were merged, i.e., 4 per cent of the amount by which the total net income exceeded the "credits," whether individual returns or a joint return were filed.

The exceptions, when a combined return is desirable even though the incomes are substantial, arise (a) in case the husband or wife has allowable charitable contributions in excess of the 15 per cent limitation, full credit for which would be lost if separate returns were made; (b) in case one spouse has a net loss which may be applied against the income of the other.

When the net income for 1921 shown in a single return exceeds $5,000, the surtaxes begin to apply. By rendering separate returns the application of the surtaxes is forestalled to the extent of an additional $5,000.[12]

In addition to the surtaxes which begin to apply when a net income reaches $5,000, there is also the 8 per cent normal rate which applies in place of the 4 per cent rate when the excess of net income over credits (personal exemptions, dividends, etc., see Chapter XII) is greater than $4,000.

In the case of a married man with no dependents (citizen or resident of the United States) having a net income of $40,000 for 1921 (none from dividends) the tax would be arrived at thus:

He receives an exemption of $2,000, pays a normal tax of 4 per cent on the next $4,000, and 8 per cent on $34,000. Surtax begins at $5,000[13] and is 1 per cent on the first $1,000 in excess of that amount, and 1 per cent additional on each $2,000 above $6,000, until it reaches 18 per cent on the last $2,000 of the $40,000.[14] The normal tax is $2,880 and the surtax $3,410, a total of $6,290.

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[12] For 1922, surtaxes begin at $6,000. See Chapter VII.

[13] *Ibid.*

[14] For 1922 the surtax rates start at 1 per cent on the first $2,000 in excess of $6,000, and are graduated upwards so that on the last $2,000 of the $40,000 the rate is 17 per cent.

If husband and wife each have an income of $20,000, each will presumably take $1,000 exemption. The normal tax is then 4 per cent on the next $4,000, and 8 per cent on $15,000. Surtax begins as before at $5,000, and runs to 8 per cent on the $2,000 between $18,000 and $20,000. The tax for each is: normal $1,360, surtax $710; total $2,070. The combined tax is $4,140, a saving of $2,150 secured by making separate returns.

WHEN WIFE SHOULD TAKE NO PART OF PERSONAL EXEMPTION.—The following illustrates when a wife should take no personal exemption.

HUSBAND'S INCOME $20,000; WIFE'S INCOME $4,000; 3 CHILDREN

METHOD A—WIFE TAKES EXEMPTION:

		Tax	
Wife's income	$4,000.00		
Less: Exemption	2,000.00[15]		
Taxable at 4 per cent.	$2,000.00	$80.00	
Husband's income	$20,000.00		
Less: Exemption (three children)	1,200.00		
	$18,800.00		
Taxable at 4 per cent.	4,000.00	160.00	
Taxable at 8 per cent.	$14,800.00	1,184.00	
Combined normal tax			$1,424.00

METHOD B—HUSBAND TAKES EXEMPTION:

Wife's income—taxable at 4 per cent.	$4,000.00	$160.00	
Husband's income	$20,000.00		
Less: Exemption	3,200.00		
	$16,800.00		
Taxable at 4 per cent.	4,000.00	160.00	
Taxable at 8 per cent.	$12,800.00	1,024.00	
Combined normal tax			1,344.00
Saving in normal tax = 4 per cent on exemption of $2,000 =			$ 80.00

[15] The personal exemption is only $2,000 since the *aggregate* net income of husband and wife is $24,000. See section 216 (c), Chapter XII.

If a wife has an income of $4,000 or less, and the husband has income which, after deducting the full personal exemption, is large enough to subject some of his income to the 8 per cent normal tax, the application of the entire personal exemption to the husband's income results in a saving equal to 4 per cent of the exemption.

Joint returns of husband and wife—when desirable.—It is well to remember that a joint return or separate returns may be rendered when husband and wife are living together, and advantage may thus be taken each year of the most advantageous basis of filing returns, as hereinbefore outlined.

RULING. Receipt is acknowledged of your letter of January 17th, 1921, in which you state that during the year 1920 your income was approximately $54,000.00. During the same period your wife suffered a net loss of $62,000.00.

You request to be advised whether under the circumstances you and your wife may file a joint return for the purpose of applying your wife's net losses against your income.

You are advised that there is no provision of the law by which a husband and wife can be denied the privilege of filing a joint return. Your wife's net losses may therefore be deducted from your income in determining income subject to both the normal tax and the surtax where you and your wife elect to file a joint return. (Letter signed by Commissioner Wm. M. Williams, and dated February 3, 1921.)

Community property.—The Attorney General, in opinions dated September 10, 1920,[16] and February 26, 1921,[17] holds that community income as defined by the laws of Texas, Washington, Arizona, Idaho, New Mexico, Louisiana, and Nevada (but not California) may be equally divided between husband and wife. Separate returns filed by husband and wife in many cases will result in a considerable saving in tax.

A full discussion of community property will be found in Chapter XIII which should guide the preparation of returns for 1921 and subsequent years.

As to the returns for years prior to 1921, amended returns

[16] C. B. 3, page 221; T. D. 3071; 32 Op. Att. Gen. 298.
[17] C. B. 4, page 238; T. D. 3138; 32 Op. Att. Gen. 443.

and claims for refund may be filed within the five-year period laid down by the 1921 law.

RULING. Amended separate returns may be filed for each of the taxing years in which the law of Texas contains a provision giving husband and wife equal rights to community property, subject to five-year limitation in section 252, Revenue Act of 1918.

Claim for credit of net amount of taxes overpaid for any of the taxing years may be filed for the amount of assessment outstanding and claim for refund filed for balance. Claim for abatement instead of claim for credit, however, should be filed for excess of tax assessed for 1919 over tax due for 1919 under amended separate returns. Claim for refund may be filed for entire net overpayment if no assessment is outstanding. Adjustment of taxes between husband and wife due on amended separate returns will be made as a matter of accounting and no claim for credit should be filed.

Any claim for abatement, refund, or credit must be accompanied by an agreement signed by husband and wife consenting to adjustments therein demanded.

In all cases in which it appears that returns are filed as a result of the ruling contained in Treasury Decision 3071,[18] and the income shown in the returns now filed was disclosed in a prior return or returns, penalty on account of delinquency will not be asserted and interest on account of failure to pay the tax shown by the returns of the date payment was required by law, will not be assessed. Where a claim for credit is filed under this ruling, bond will not be required.

Claims for credit may be filed for unpaid additional taxes assessed under office ruling 43-20-1270.[19]

Should the above outlined procedure not cover any specific case which may arise, the facts therein should be presented to this office for a specific ruling. (C. B. 3, page 310 O. D. 757.)

The above ruling under the 1918 law applies specifically to Texas, but it can equally well apply to the other states having community property laws (listed above). The claims will now be made under section 252 of the 1921 law.

With the amended returns a claim for refund, credit, or abatement must be filed in order to adjust the excess tax paid by one spouse. Although the ruling is not commendable for its clarity, a subsequent decision[20] confirms the inference that

[18] See Chapter XIII.
[19] C. B. 3, page 300.
[20] C. B. 4, page 335; O. D. 854.

underpayment by one spouse may be offset against overpayment by the other. Claim is to be filed for the excess.

Change of domicile does not affect the right to render amended returns.

RULING. A husband and wife, who were domiciled in Texas, January 1, 1918, and abandoned that domicile in August, 1919, the husband having included in his 1918 and 1919 income tax returns income received from all sources including personal earnings and no returns having been filed by the wife, may file amended separate returns for 1918, each reporting as gross income one-half the income received during that year which constituted community income as defined in T. D. 3071. They may also file amended separate returns for 1919, each reporting as gross income one-half the income, received prior to the abandonment of the marital domicile in Texas, which constituted community income as so defined.

The date of the abandonment of the Texas domicile is determined by the application to the facts in the case of general principles of law. (C. B. 4, page 235; O. D. 810.)

Change of domicile does not cause the forfeiture of the right to file separate returns of income from community property acquired while domiciled in a state in which community property laws are in effect.

RULING. Where husband and wife acquire community property while domiciled in the State of Idaho, and then take up domicile in California, they may continue to render separate returns of the income from such property. (B. Digest 39-21-1845; S. O. 121.)

Returns by minors.—Minors in receipt of taxable income are required to make returns, or returns must be made for them.

REGULATION. An individual under the statutory age of majority is required to render a return of income if he has a net income of his own of $1,000 or over, or a gross income of $5,000 or over, for the taxable year.[21] If he is married, see article 401.[22] If a minor has been emancipated by his parent his earnings are his own income, and such earnings, regardless of amount, are not required to be included in the return of the parent. If the aggregate of the net income of a minor from any property which he possesses, and from any funds

[21] **[Former Procedure]** Under the 1916 and 1917 laws, the returns of minors were filed by their guardians (Reg. 33, 1918, Art. 27). The words "of lawful age" are omitted from section 223 of the 1918 law, requiring returns of "every individual," etc.

[22] See page 76.

held in trust for him by a trustee or guardian, and from his earnings in case he has been emancipated, is at least $1,000, or his gross income is at least $5,000, a return as in the case of any other individual must be made by him or by his guardian, or some other person charged with the care of his person or property for him.[23] In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return. (Art. 403.)

The latter part of the article which holds that a parent will be assumed to have the legal right to the earnings of his minor child is reasonable, otherwise minor children with taxable incomes might erroneously assume that they were not individually responsible for making returns and the parent in turn might assume that, since the minor had a taxable income, the latter was responsible for the making of a return.

It has been stated that the Treasury has advised taxpayers that the mere failure of a parent to assert his right to appropriate the earnings of his minor child does not constitute emancipation within the meaning of the income tax law; also that where a parent relinquishes his right to appropriate, such earnings are constructive income to the parent and are considered as gifts to the minor, and consequently are not deductible in computing the parent's net income subject to income tax.

In view of the reluctance of the courts to impute taxable income to a taxpayer when none has actually been received, this far-fetched doctrine of constructive receipt is hardly likely to be adopted.

The question then arises—what constitutes emancipation? The courts have held[24] that:

Emancipation of a minor occurs by the voluntary act of the parent in surrendering the rights or renouncing the duties of his position, or in some way conducting himself in relation thereto in a manner inconsistent with any further performance of them. The emancipation may be expressed or implied, or in writing or oral. The test to be applied is that of the preservation or destruction of the parental and filial relations. The child's arrival at the age of majority

[23] See Article 422.
[24] 29 Cyc. 1673, citing cases.

is prima facie, but not necessarily, an emancipation. The marriage of the child is an emancipation from the control and authority of the parent, even though the parent did not consent to the marriage. . . . . The father's desertion of a minor child will operate as an emancipation; but the child's desertion of the father's home does not constitute emancipation so long as the father has not relinquished his right of control or consented that the child should act for himself independently of the father. The fact that the child is allowed to live away from the parent does not amount to an emancipation, unless it is the intention of the parent to release all parental authority and control. On the other hand the fact that the son lives in the family of the father does not establish that he is not emancipated. . . . . The payment of a weekly allowance by the parent to the child does not constitute emancipation. Where a father who is able to support his minor son forces him to leave home and labor abroad for a livelihood, the law implies an emancipation. So also an infant is emancipated where he supports himself and pays his board at home, or where the parent allows him to carry on a business for himself and exercises no control over him or his earnings. Where the child contracts for his services and collects and uses his own earnings, emancipation is to be inferred; but a complete emancipation does not necessarily result from the fact that the father allows the child to receive and spend his own wages, or even to contract for his services. If the father gives or sells the child his time the law implies emancipation.

It thus appears that the Treasury has adopted a rather narrow interpretation of the law and one that will be modified later in favor of the taxpayer.

The requirement [section (a-3)] that returns must be made if *gross* income is $5,000 or over, applies also to minors.

Returns by soldiers and sailors.—All persons in the military or naval service of the United States who are unable to file returns within the statutory time limit may obtain an extension of time, or returns may be made for them by agents. They may file their returns in "the district in which they have a legal residence, or with the collector of internal revenue at Baltimore, Maryland."[25]

REGULATION. . . . . persons in the military or naval service of the United States, may file their returns of income with the collector of Baltimore. (Art. 447; Reg. 45, Art. 448.)

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[25] For verification of such returns, see page 78.

Returns by fiduciaries.—The duties of fiduciaries (including their liability to make returns, and the procedure therefor) are fully explained in Chapter XXXVII. The law[26] classes fiduciaries as individuals in so far as returns are concerned.

Income from partnerships included in individual returns of partners.—The individual returns of partners for 1921 should include the entire distributive shares credited to such partners "for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partners' net income is computed."[27]

Many partners have all their personal accounts, including income from investments, etc., kept in the partnership books, and so far as an accounting period is concerned have never recognized the calendar year except for federal income tax requirements. If it is more convenient for a partner to make a return at some date other than as of December 31, he should apply for permission to make the change.

When there is income from partnerships and the partnerships' accounting periods are fiscal years during which different rates of tax are in effect, three steps must be considered in the returns of individuals:

(a) Partners must report their share of the income of the partnership credited to them on the last day of the month which marked the close of the partnerships' fiscal years.[28]

(b) The partnership income must be divided into the shares applicable to each of the calendar years, included in the fiscal year.[29]

(c) Such partnership income is then taxed to the individual partners at the rates obtaining during the calendar years to which it is allocated.[30]

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[26] Section 225.

[27] Section 218 (a).

[28] Section 218 (a).

[29] Section 205 (c). This does not apply to fiscal years ending in 1921 as the 1920 and 1921 rates are the same.

[30] *Ibid.*

Assume the case of a partnership with a fiscal year ending June 30, 1922, and with a taxable net income of $120,000. A partner owning one-half interest in the partnership, having income from other sources of $80,000, and reporting on a calendar year basis, would prepare his 1922 return as follows:

Other income		$ 80,000	taxable at 1922 rates
Partnership income (½)	$60,000		
Partnership income allocated to 1922		30,000	taxable at 1922 rates
		$110,000	total taxable at 1922 rates
Partnership income allocated to 1921		30,000	taxable at 1921 rates
Total net income for 1922		$140,000	

The author has protested against the inequity of the method of superimposition of income attributable to a prior year on the income of the current year, and has suggested that such income be superimposed on the income already reported for the previous year.[31]

Congress did not re-enact in the 1921 law the provisions of section 206 of the 1918 law. It would seem clear, therefore, that they intended to give the taxpayer relief from the former inequitable method. No specific method is provided in the new law as to how such income is to be reported and taxed, but the Treasury has now, by regulation, provided for the superimposition of the income, earned during the prior year by a partnership, on the other income of the individual for the current year at the rates of the preceding year. (See article 335.)

Section 206 of the 1918 law[32] provided for superimposition

[31] *Income Tax Procedure,* 1919, pages 122-124; *Income Tax Procedure,* 1920, pages 152-157.

[32] **[Former Procedure]** Section 206 of the 1918 law reads:

"That whenever parts of a taxpayer's income are subject to rates for different calendar years, the part subject to the rates for the most recent calendar year shall be placed in the lower brackets of the rate schedule provided in this title, the part subject to the rates for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to that year, and so on until the entire net income has been accounted for. In determining the income, any deductions, exemptions or credits of a kind not plainly and properly chargeable against the income

of the income attributed to a preceding year upon the income subject to the current year's rate. For instance, the $30,000 in the above example taxable at the 1921 rates would be subjected to the surtax rates for 1921, beginning at $110,000 and running up to $140,000. This method resulted in an increase of tax when the income of the taxpayer was greater in one year than in the preceding year. Conversely, it resulted in a decrease of tax when the income of a taxpayer decreased as compared with a preceding year. Accordingly there was a penalty, or bonus, in changing to a fiscal year basis, depending upon the income received in the current year as compared with the preceding year. This method has been continued in the new regulations.

Incorporation of a partnership or of an individual—return as a corporation.—The 1921 law provides[83] that under certain conditions the income of a business organized as a corporation within four months after the passage of the act (the act was passed November 23, 1921) may, at the option of the individual or partnership, be treated as if such corporation had been in existence on and after January 1, 1921, and make return accordingly. For full discussion of procedure, see Chapter XXIV.

Annual Returns by Corporations

For 1921, corporations are required to file income and excess profits tax returns. For 1922 and subsequent years, income tax returns only are required.

Corporations which are specifically exempt under the law[84] need make no annual return; but, it will be recalled, must in certain cases establish the fact of their exemption.

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taxable at rates for a preceding year shall first be applied against the income subject to rates for the most recent calendar year; but any balance thereof shall be applied against the income subject to the rates of the next preceding year or years until fully allowed."

[83] Section 229.

[84] See page 34.

All other corporations must file returns, regardless of the amount of their net income. But when corporations have taxable income of $3,000 or less, the excess profits data need not be furnished.

LAW. Section 239. **(a) That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. . . . .**

Corporations are required to file returns for their accounting periods, the same as are individuals.[35] If corporations have been closing their books on a fiscal year basis and reporting on a calendar year basis, they must change their method and report for fiscal years.

Return sworn to by two officials.—

LAW. Section 239. **(a) . . . . The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. . . . .**

When only one officer is available, the officer signing the return may sign for the other in the latter's official capacity.[36]

"Corporation" defined.—The law[37] states that the term "corporation" shall include "associations, joint-stock companies and insurance companies." Under the latest rulings limited partnerships are or are not corporations, depending upon their type.[38] Massachusetts trusts have been held not to be associations.[39]

Domestic corporations, for the purpose of the revenue act, are those organized in the United States, which include only the states, the District of Columbia, and the territories of Alaska and Hawaii. Those created outside these limits are foreign corporations.

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[35] See page 64.
[36] C. B. 4, page 307.
[37] Section 1.
[38] See Chapter XXIV.
[39] See page 93.

The Treasury has held, however, that a corporation receiving a charter from the United States Court for China, and holding itself out to be a corporation under the laws of the United States, will, for tax purposes, be considered a domestic corporation.[40]

JOINT-STOCK COMPANIES AND ASSOCIATIONS.—

REGULATION. Associations and joint-stock companies include associations, common-law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization. A corporation which has ceased to exist in contemplation of law but continues its business in corporate form is an association or corporation within the meaning of section 2, but if it continues its business in the form of a trust, it becomes subject to the provisions of section 219. (Art. 1502.)

The last sentence of this article is new.

SYNDICATES AND JOINT ADVENTURES.—The ordinary syndicates and joint adventures are held not to be associations.[41] But a syndicate where "a shareholder's certificate entitles him to share in the distribution of profits during the life of the enterprise, to share in the distribution of assets upon dissolution, and to vote on questions affecting the management and control of the business," was held to be an association.[42]

Mining "partnerships" in Colorado and Idaho have been held to be associations because the shares are transferable and because such an organization "in all its essential elements is precisely like a corporation."[43]

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[40] C. B. 3, page 19; O. D. 661.
[41] Reg. 45, Art. 1507.
[42] C. B. 4, page 9; O. D. 806.
[43] B. 45-21-1902; A. R. R. 652.

The courts[44] have differentiated a trust from an association, holding that:

An organization, in form a trust, created by an agreement of the stockholders of several street railway corporations desiring to effect a unitary control of the properties of such corporations, is an association within Section II, Paragraph G (a), of the Act, where the agreement uses language that reads much like the state corporation law, and superimposes that organization upon the several corporations by placing the legal title to the capital stock of those corporations in the trustees named, who are to do certain specified things only, and by providing for a committee which controls even the power of the trustees to vote the capital stock of the corporations, and which is elected and controlled by what are called participating shareholders, who hold certificates of common and preferred participating shares issued by the trustees in lieu of the capital stocks of the corporations.

An association may be organized independently of any statute, and when so organized is nevertheless subject to income tax as such.

This case was decided under the 1913 law, but the same principle will apply under all later statutes.

Association distinguished from partnership.—

Regulation. An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership. (Art. 1503.)

A bank which had issued certificates of ownership was held not to be an association but a partnership. Certificates could not be transferred without the consent of the other members, and each member was liable for all debts.[45]

A private banking institution, unincorporated, where the

[44] *Chicago Title & Trust Company as Trustee v. Smietanka, Collector,* U. S. District Court, Northern District of Illinois, Eastern Division, March 14, 1921 (not reported, see T. D. 3193, July 1, 1921).

[45] B. 44-21-1895; O. D. 1083.

interests were transferable without the consent of the other members, was held to be an association.[46]

Massachusetts trusts.—Massachusetts trusts have grown up in part because, until about ten years ago, it was not possible to organize a corporation under the Massachusetts law to own and operate real estate. Out of the common practice of putting real estate in the hands of trustees for legal ownership and management, with certificates issued to the beneficiaries, grew the practice of carrying on other lines of business with the same trust organization in cases where it was considered that a trust was preferable to a corporation. Hence, in practice, there are all kinds of Massachusetts trusts. In some the beneficiaries have little or no control over the management of the trust; others have practically all the characteristics of corporations (except the actual corporate existence and the limited liability of a stockholder in a corporation), and are governed by elaborate by-laws providing for annual meetings of certificate holders, and for the election of trustees for relatively short periods of time, thus vesting a large measure of control in certificate holders.

From a tax standpoint the question is: Is a Massachusetts trust an ordinary trust or an association? If the latter, it is taxable as a corporation. If the former, the income, if distributable, is taxable to the beneficiaries.

In the case of *Crocker v. Malley*,[47] the court pointed out that, by the terms of the trust, the beneficiaries were "trust beneficiaries only, without partnership, association or other relation whatever inter sese." It also pointed out that the trustees had discretion to distribute income or to add it to capital, although in fact they did make complete distribution, and that the beneficiaries had no control over the management of the trust, except that they must assent to any increase of the trustees' compensation, to the filling of vacancies among

[46] I-1-1, I. T. 1150.
[47] 249 U. S. 223; 63 L. Ed. 573; 39 Sup. Ct. 270; 2 A. L. R. 1001.

the trustees and to the modification of the terms of the trust. In this case also, the purpose of the trust was not to run a business, but to hold certain shares of stock and property for a limited period of years, preparatory to liquidation of the trust property. Upon these facts the court found that the trust did not have the attributes of an association, and that the provisions of the Income Tax Act of October 3, 1913, section II, G (a), did not require that such a trust be treated as a corporation for the purpose of taxation. The opinion in the case does not deal directly with the question whether the trust, as a trust, or the beneficiaries are accountable for a tax on the dividends received by the trust, because under the withholding provisions of the 1913 act, the trustees were liable to make a payment of tax in any event, whether they were taxable themselves or merely paid on behalf of the beneficiaries.

The test laid down by the Treasury is whether the beneficiaries have a voice in the business.

Ruling. Where beneficiaries holding certificates evidencing their interest under a so-called 'Massachusetts trust' agreement annually elect persons delegated to conduct the affairs of the trusts, thus retaining a voice in the business, the trust is an association and is subject to the normal tax upon its income under the Acts of 1913, 1916, and 1918; the excess profits tax under the Acts of 1917 and 1918; the capital stock tax under the Acts of 1916 and 1918; and the certificates issued by the trust to the beneficiaries are subject to the stamp tax under the Acts of 1917 and 1918.

Where the trustees originally appointed were to hold office during the entire period of the trust, the right of the shareholders being limited to filling vacancies, the beneficiaries not retaining any substantial control over the affairs of the trust, such a trust is not an association or taxable as such under section 230 of the act of 1918, but under section 219 relating to trusts. They are not subject to the excess profits tax nor the capital stock tax, nor are the certificates issued by the trustees subject to stamp tax. (C. B. 1, page 5; S. 1068.)

The question, whether beneficiaries in such trusts must return their distributive shares of income of the trust, or merely the income which is distributed to them, answers itself in accordance with the general rules applicable to corporations and trusts. Clearly, if the trust is of such a nature that it

must be taxed as a corporation, its distributions are dividends and its shareholders have no taxable interest in its undistributed earnings. On the other hand, if the trust upon its peculiar facts is classifiable for tax purposes as a trust, and not as a corporation, the question whether the beneficiaries must return their distributive shares of income, or only the income distributed to them, depends upon their rights under the trust to have income distributed. In the *Crocker* case the trustees had discretion to distribute income or to add it to capital. According to the Treasury,[48] in such a case all the income would be taxed to the trustees. It would seem, however, that the language in section 219 (a-3) and (c), which makes income taxable to the trustees if "held for future distribution under the terms of the will or trust," looks to the act of the trustee under his authority given by the trust instrument as determining whether or not the income, under the language of the statute, is "held for future distribution."

Returns of incomplete and inactive corporations.—In the language of section 239, "every corporation subject to taxation under this title"[49] must make a return.[50] Consequently all corporations, no matter how small the income or whether or not they have any income at all, provided only that as corporations they are subject to the tax, must file a return. Such corporations, if in existence during any part of the year, are liable and must report from the first of the year to the date of dissolution or liquidation, or from the date of incorporation to the end of the taxable year.

The general rule is that, "so long as it has the right to function as a corporation under the laws of the State in which it was incorporated, regardless of whether or not it received

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[48] C. B. 1, page 176; S. 1088.

[49] "And every personal service corporation" but such corporations are exempt under this title (section 239).

[50] Section 13 (b) of the 1917 law reads, "every corporation not specifically enumerated as exempt shall make return of annual net income whether or not it may have for the particular year any net income."

any income during the period for which the return is rendered," a return must be made.[51]

It has been held that a return must be filed although the organization as a corporation has not been completed;[52] where a single stockholder acquires all the stock and continues the business, the corporation is not thereby dissolved;[53] where after expiration of the charter by limitation, its business is continued in the corporate form.[54] A stockholder purchased the business of a corporation, operated the same as an individual, filed a "change of attitude" with the Secretary of State in Michigan. A return was required because it was held that the corporation was not dissolved but its powers merely suspended.[55]

As was pointed out by the Solicitor in the first ruling cited, the question whether a corporation has been properly organized or not is a question which cannot be raised collaterally.

REGULATION. . . . . A corporation having an existence during any portion of a taxable year is required to make a return. A corporation which has received a charter, but has never perfected its organization, and which has transacted no business and had no income from any source, may upon presentation of the facts to the collector be relieved from the necessity of making a return so long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. A corporation which was dissolved in 1921 prior to the enactment of the present statute is not relieved from the necessity of rendering returns thereunder for such portion of 1921 as elapsed before its dissolution. . . . . (Art. 621.)

RULING. A charter was granted A and B in 1915 to carry on business as a corporation. The charter was granted under section 2823 of the Civil Code of Georgia, which provides in part that "* * * No charter shall have any force or effect for a longer period than two years unless the corporation, within that time, shall in good faith commence to exercise the powers granted by the act of incorporation * * *." Prior to the application for a charter A and B operated the business as a partnership, and since the granting of the charter

[51] C. B. 4, page 307; O. D. 882.
[52] C. B. 1, page 233; S. 972. But see also Art. 621.
[53] C. B. 4, page 302; S. O. 91.
[54] C. B. 4, page 305; S. O. 93.
[55] C. B. 4, page 308; O. D. 919.

they have continued its operation as a partnership. Corporation returns were filed for 1916, 1917, and 1918. No articles of incorporation or by-laws exist; no meeting of the stockholders was ever held; no stock was issued nor any officers elected; and the company has never held itself out as a corporation in any of its dealings and has never brought suit nor been sued as a corporation. The company has always been taxed for State, county, and school purposes as a copartnership.

Held, that the organization of A and B never existed either as a de jure or a de facto corporation. (B. 43-21-1887; O. D. 1078.)

When a change is made from the corporate form to single proprietorship or partnership, corporations are not always formally dissolved. Care should be taken in such cases to observe all legal requirements, or the Treasury may require corporation returns to be made, even though entries have been made on the books transferring the assets. This comment is particularly applicable to those closely held corporations in which there is laxity in the holding of stockholders' meetings and proper authorization of the acts of the officers.

In general, if the business is continued under the corporate form, the Treasury takes the position that such an organization, if not a corporation *de jure* or *de facto*, is an association.[56]

The Treasury may not require a return if a proper statement of the facts is made.

RULING. The M Company was incorporated in July, 1919, but did not commence business until September 1, 1919, on which date the corporation opened its books and established a fiscal year ending August 31.

In March, 1920, it filed a return for the fractional part of the year from September 1, 1919, to December 31, 1919, but failed to render a return for the fractional period from July, 1919, to August 31, 1919, during which time it remained in an unorganized condition and had no income.

Article 621, Regulations 45, provides that a corporation which has received a charter but has not perfected its organization and received no income, may, upon presentation of the facts to the collector, be relieved of the necessity of making a return for the fractional period during which it remained in an unorganized condition and had no income.

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[56] C. B. 4, page 305; Sol. Op. 93.

Held, that a failure to make such presentation of facts on or before November 15, 1919, the last due date of the return for the period July, 1919, to August 31, 1919, will be construed as a waiver of the privilege on the part of the taxpayer; a return covering the fractional period July, 1919, to August 31, 1919, accompanied with an affidavit stating the reason for the delay in filing, will accordingly be required, although there was no income for the period. (B. 48-21-1951; O. D. 1120.)

RULING. The M Company was formed by incorporating the business of a copartnership. It was intended that the business of the partnership would be transferred to the new corporation as of May —, 1920, the beginning of the partnership's fiscal year, but the necessary legal preliminaries were not begun in time and the charter of the corporation was not issued until October —, 1920. However, the employees were sold the common stock at par with the understanding that they would thereby share proportionately in the profits from May —, and in transferring the business the corporation assumed the operation thereof from May — and entered the same on its books.

Inquiry is made as to whether or not it is proper for the corporation to make return for the 12 months ending April —, 1921, and report as its net income the net income of the business for this period.

It is held that October —, 1920, is the date to be taken as the beginning of the period to be covered by the return of the M Company and, therefore, the corporation can not make return for the 12 months ending April —, 1921. The corporation was not in existence nor did it receive income prior to October —, 1920. (B. 35-21-1796; O. D. 1016.)

The foregoing ruling is not consistent with the position taken by the Treasury in those cases where it was held that a return must be made as a corporation even though the corporate organization has not been completed. In another case the Treasury held that the taxable period of the corporation began as of the date of the issuance of the certificate by the Secretary of State.[57]

RULING. In accordance with the terms of a contract between the O Corporation and the M Corporation, the assets and liabilities of the O Corporation were transferred to the M Corporation on December 31, 1919, and the M Corporation was to have the income received by the O Corporation between October 4, 1919, and December 31, 1919, the end of its taxable year.

Held, that each corporation is required to render a return for its

[57] B. 48-21-1952; O. D. 1121.

full taxable year and that the O Corporation must include in its return the entire income received in 1919, including any gain realized from the sale of its assets to the M Corporation. (B. 36-21-1808; O. D. 1025.)

It is proper that returns should cover the full period during which both corporations were in existence; but the ruling should have stated that the O corporation could claim as an allowable deduction the income turned over after October 4 to the M corporation. The net income after October 4 was taxable income only to the corporation which retained it.

Return by new corporation.—The provision in the 1918 law[58] with reference to the making of a *first* return in case of a fiscal year, was never clear and has been repealed. In making a first return a corporation simply makes return on the basis of its fiscal year. No notice to the Commissioner of the date of the close of the fiscal year is required from a new corporation.

Holding companies with income only from dividends must make returns.—Section 239, quoted on page 90, appears to include holding companies receiving no income other than dividends from subsidiaries. Dividends received by a corporation must be reported as gross income [section 233 (a) and section 213] even though they are deducted in order to ascertain net income. If any doubt arises concerning the liability of holding companies to submit returns, the Commis-

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[58] **[Former Procedure]** Section 226 of the 1918 law provides: "If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year."

In answer to an inquiry as to the method of reporting used by a corporation which organized on October 1, 1918, and wished to establish September 30, 1919, as its first fiscal period, Commissioner Roper on March 12, 1919, advised as follows: "If your books are kept on basis of a fiscal year ending September thirtieth you should file your first corporate income tax return upon basis of such fiscal year ending in nineteen nineteen on or before December fifteenth, nineteen nineteen. No notice of date of close of fiscal year required." This interpretation obviated any necessity for reporting a fractional part of the year when a new corporation did not wish to do so.

sioner will undoubtedly require such returns through an exercise of his power under section 1307 to demand returns whenever in his judgment he considers them "necessary."[59]

Return of foreign corporation filed by agent.—

LAW. Section 239. (a) . . . . **If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. . . .**

REGULATION. Every foreign corporation[60] and corporations satisfying the conditions set forth under section 262, having income from sources within the United States, must make a return of income on Form 1120. If such a corporation has no office or place of business here, but has a resident agent, he shall make the return. It is not necessary, however, for it to be required to make a return that the foreign corporation shall be engaged in business in this country or that it have any office, branch, or agency in the United States. (Art. 625.)

The first sentence of this article has been changed to give effect to corporations entitled to the benefits of section 262 of the law.

Returns of insurance companies.—The new law[61] provides for taxation of life insurance companies on the basis of investment income only. No excess profits tax return or capital stock tax return is to be made for 1921, as is the case with ordinary corporations. Beginning with 1922, insurance companies[62] (other than life or mutual insurance companies) make special returns in lieu of the ordinary income and capital stock tax returns. For detailed discussion, see Chapter XXXVIII.

Returns of mergers, reorganizations and corporations with changed names.—

REGULATION. (*a*) Where corporations are affiliated at the beginning of a taxable year but due to a change in stock ownership or control during the year the affiliated status is terminated, or (*b*) where corporations are not affiliated at the beginning of the taxable

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[59] See Chapter III.
[60] For special provisions applying to foreign life insurance companies, see Chapter XXXVIII.
[61] Section 243.
[62] Section 246.

year but through change of stock ownership or control during the year become affiliated, a full disclosure of the circumstances of such changes of stock ownership shall be submitted to the Commissioner. Ordinarily in such cases the parent or principal company, under the conditions described in (*a*) above, should exclude from its return the income and invested capital of such subsidiary or subordinate company from the date of the change of stock ownership, and under the conditions described in (*b*) above, should include in its return the income and invested capital of such subsidiary or subordinate company from the date of the change of stock ownership. In either case the subsidiary or subordinate corporation whose status is changed during the taxable year should make a separate return for that part of the taxable year during which it was outside of the affiliated group.

Where, in accordance with the procedure set forth above, a return is made by a corporation for a period less than a year, the tax shall be computed in accordance with sections 226 and 239 and the articles thereunder. In any case in which the change of consolidated status is for a period so short as to be negligible, a consolidated return or separate returns for the entire period, as the case may be, may be filed; in such cases, however, there should accompany the return a complete statement setting forth the changes in the affiliated status occurring during the taxable year. (Art. 634.)

The new article takes into account the option available to affiliated corporations after January 1, 1922, to file separate or consolidated returns. It also clarifies the procedure to be followed.

It may be necessary to file three or more returns for a single year in case of merger—one for each corporation before the merger, covering the portion of the year during which the corporations existed as separate entities, and one for the merged corporation after consolidation. When the change consists of the absorption of one company by another and the effect has been merely the enlargement of the absorbing corporation, separate returns for the companies before and after the merger are not required. Generally speaking, it is not advantageous to file separate returns when consolidated returns may be filed.

In what are known as "seasonal" businesses, care should be taken to avoid making a change at a time of year when there may be a net loss for the period elapsed since the

beginning of the fiscal year. Although, under the 1921 law,[63] a net loss may be carried forward and "deducted from the net income of *the* taxpayer for the succeeding year," such net loss could not be taken advantage of by a *successor* corporation.

Returns by receivers, trustees in bankruptcy or assignees.—

LAW. Section 239. **(a) . . . . In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.**

REGULATIONS. A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. . . . . In general, statutory receivers and common law receivers of all the property or business of an individual or corporation must make returns. . . . . (Art. 424.)

When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution, however they may have appreciated or depreciated in value since their acquisition. . . . . (Art. 548; Reg. 45, Art. 547.)

Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations on form 1120, covering each year or part of a year during which they are in control. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee, or assignee stands in the place of

[63] Section 204.

the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. A receiver in charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income. . . . (Art. 622.)

Consolidated returns.—Affiliated corporations[64] are required by the new law to make consolidated returns for 1921 in the same manner as is provided by the 1918 law.[65] For 1922 and subsequent years, affiliated corporations may file consolidated returns or separate returns for each corporation, at the option of the taxpayer. However, once the option is exercised, returns must be made on the same basis thereafter. Careful consideration should be given, therefore, before deciding which basis to adopt.

From the standpoint of income tax, it makes little difference whether or not the accounts of affiliated concerns are consolidated, unless one or more of a group should be losing money. In such a case, under separate returns no credit could be taken for the loss, in the current year's return; a net loss, however, could be carried forward.

An attempt might be made in such circumstances to shift some of the profit to a losing subsidiary, but a new provision of the 1921 law gives the Commissioner power to consolidate the accounts of "two or more related trades or businesses . . . . owned or controlled directly or indirectly by the same interests . . . . for the purpose of making an accurate distribution or apportionment of gains, profits, income . . . ."[66] Under these largely increased powers, it may be expected that

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[77] **[Former Procedure]** There was a similar specific requirement in the 1918 law. The 1917 law specified that the return include information regarding "the tax years and the applicable amounts in which such dividends were earned." This was necessary because in 1917 dividends were taxable at the rates which were in force during the years to which the dividends were applicable, under the rule that dividends were deemed to have been paid out of most recently accumulated surplus (1917 law, section 26).

[64] For definition of affiliated corporation, See *Excess Profits Tax Procedure*, 1921, page 308.

[65] Section 240 (c). See Chapter XIV of Appendix A.

[66] Section 240 (d).

the Commissioner will exercise them in those cases where the income or deductions are illegally shifted. If minority interests are not affected, there is nothing illegal or immoral in shifting profits or losses in order to bring about an equitable tax burden.

CONSOLIDATED RETURNS AFTER JANUARY 1, 1922.—

LAW. Section 240. **(a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922,[67] make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner. . . . .**

If the tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit.

[67] **[Former Procedure]** Under the 1918 law, consolidated returns were required for both income and profits taxes (see *Excess Profits Tax Procedure,* 1921, Chapter XIV). No specific provision in the 1917 law required the filing of consolidated returns; but by regulation (Reg. 41, Arts. 77 and 78) the Treasury, under the general provision of section 201, required the filing of consolidated returns for excess profits tax in the case of corporations, when there was either substantial stock ownership, or close financial relationship or control. Partnerships, which in 1917 were subject to excess profits tax, were, under the 1917 regulations, neither required nor permitted to make consolidated return. In a specific case the Treasury refused to accept a consolidated return where a partnership was affiliated with a corporation.

Considerable doubt as to the right of the Treasury to require any consolidated returns under the 1917 law, gave rise to the inclusion in the 1921 law of section 1331, declaratory of the 1917 law, in effect validating Reg. 41, Arts. 77 and 78, referred to above.

A comparison of the language of section 1331 of the 1921 law, with that of Reg. 41, Arts. 77 and 79, reveals the fact that while section 1331 follows the wording of the regulations, an important change is made in that the law specifically treats partnerships on the same basis as corporations as regards affiliation. Under this section, amended returns may be desirable and necessary in those cases in which a partnership has previously been denied affiliation either with another partnership or with a corporation.

Under previous *income* tax laws, prior to 1918, every corporation was held to be "a separate and distinct entity" and the tax was imposed upon each separately. If the subsidiary corporations had merely a nominal existence, however, being integral parts of the parent corporation, they were held not to be separately taxable (Reg. 33, 1918, Art. 208).

The distribution of the tax among the affiliated corporations may be made on the basis of the net income properly assignable to each, or as may be agreed upon between them.[68]

FOREIGN AFFILIATED CORPORATIONS—AND CORPORATIONS HAVING INCOME FROM UNITED STATES POSSESSIONS.—A foreign corporation cannot be included in a consolidated return, since section 240 applies only to domestic corporations. A corporation entitled to the benefits of section 262[69] (receiving the major portion of its income from sources within possessions of the United States) is treated as a foreign corporation, and cannot, therefore, be included in a consolidated return.[70]

The subject of consolidated returns is fully dealt with in the author's *Excess Profits Tax Procedure,* 1921, Chapters XIII and XIV.

New "government contract" corporations must make separate returns.—Since consolidated returns for 1921 are to be made "subject to the same conditions as provided by the Revenue Act of 1918,"[71] the following sections of that law apply to certain corporations in 1921, but will not apply in 1922 because sections 240 (a) and 1408 of the 1918 law have not been re-enacted in the new law.

1918 LAW. Section 240. (a) . . . . Provided, That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income. . . . .

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[68] Section 240 (b). See page 209.
[69] See Chapter XXXVI.
[70] Section 240 (d).
[71] Section 240 (e).

The intention of this section evidently was to prohibit any relief to a new subsidiary corporation organized by an existing corporation to handle war contracts.

1918 LAW. Section 1408. . . . . **The Commissioner shall (when not violative of the technical military or naval secrets of the Government) have access to all information and data relating to any such contract, undertaking or agreement, in the possession, control or custody of any department, bureau, board, agency, officer or commission of the United States, and may call upon any such department, bureau, board, agency, officer or commission for a full statement and description of any allowance for amortization, obsolescence, depreciation or loss, or of any valuation, appraisal, adjustment, or final settlement, made in pursuance of any such contract, undertaking, or agreement.**

COPIES OF GOVERNMENT CONTRACTS.—

1918 LAW. Section 1408. **That every person who on or after April 6, 1917, has entered into any contract, undertaking, or agreement, with the United States, or with any department, bureau, officer, commission, board, or agency under the United States or acting in its behalf, or with any other person having contract relations with the United States, for the performance of any work or the supplying of any materials or property for the use of or for the account of the United States, shall, within thirty days after a request of the Commissioner therefor, file with the Commissioner a true and correct copy of every such contract, undertaking, or agreement.**

Whoever fails to comply with such request of the Commissioner shall be guilty of a misdemeanor and shall be punished by a fine of not more than $1,000, or by imprisonment for not more than one year, or both. . . . . .

"GOVERNMENT CONTRACTS" DEFINED.—[72]

REGULATION. Government contracts may include (*a*) a contract with the United States, (*b*) a contract with an agency of the United States, (*c*) a contract with an agency of such agency, and (*d*) a subcontract with a contractor under any such contract; provided in every case the contract or subcontract is for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917 and November 11, 1918, both dates inclusive," includes contracts which although entered into during such period were originally not enforceable but which have been or may become enforceable by reason of subsequent validation in pursuance of law. . . . . The realization by a corporation of income from a

[72] See section 1, and Chapter XV. Also see *Excess Profits Tax Procedure* 1921, Chapter XVIII, and Appendix A of this volume.

Government contract may affect its status under the consolidated returns provision and the amount of its war profits and excess profits tax.[73] . . . . (Art. 1510.)

The Treasury has also held that "a contract entered into subsequent to November 11, 1918, which is supplementary to an original contract . . . ." is to be treated as a government contract.[74]

Return of earnings allocated to distributions.—The 1921 law contains a new provision relative to furnishing with the corporation return a statement of the allocation of earnings to distributions made by a corporation.

LAW. Section 239. . . . . **(c) There shall be included in the return or appended thereto a statement of such facts as will enable the Commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated during the taxable year for which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year.**

The general rule is that dividends are deemed to be paid from the "most recently accumulated earnings or profits,"[75] and the above requirement will more readily enable the Treasury to make the proper allocation.[76] What is desired is the amount of each dividend only, not the names of stockholders to whom they are payable.

The Treasury has been sending out to taxpayers a form of surplus and profit and loss analysis, from which the information called for in the above provision of the law is obtainable.

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[73] **[Former Procedure]** The following sentence was found in Art. 1510, Reg. 45: "The agreements for the operation of transportation systems while under federal control and for the just compensation of their owners made pursuant to the Act of March 21, 1918, are not Government contracts within the meaning of this article."

[74] See Chapter XV.

[75] Section 201 (b).

[76] For discussion of how the allocation should be made, see Chapter XXII.

Miscellaneous "Information" Returns

Corporation returns of dividends paid.—In order that the Treasury may be able to check the returns of those who receive dividends the law provides that, upon request by the Commissioner, corporations must file returns of dividends paid.

LAW. Section 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.[77]

The following regulation makes it clear that the return may be required in the discretion of the Commissioner.

REGULATION. When directed by the Commissioner, either specially or by general regulation, every domestic or resident foreign corporation and every personal service corporation shall render a return on form 1097 of its payments of dividends and distributions to stockholders for such period as may be specified, stating the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid him, and when the surplus out of which it was paid was accumulated. Art. 1060. (Reg. 45, Art. 1051.)

CHAPTER V

AMENDMENT AND EXAMINATION OF RETURNS

After returns are made questions may arise with regard to their amendment, their examination by the Treasury, and their inspection by outsiders. These questions are discussed in this chapter.

Amended Returns

The discovery that error exists in returns previously filed may occasion a request for an amended return either from the government or from the taxpayer.[1] In regard to corporations the instructions from the Commissioner to collectors are as follows:

RULING. All returns should be carefully scrutinized, and, if improperly prepared, they should be returned to the taxpayer for correction, with instructions that if a new return be executed, the old one, showing the date of the receipt thereon, should be forwarded to the collector to avoid the possibility of subjecting the taxpayer to additional tax or penalties for failure to file the return within the period required by law.

A record of each return sent back to the taxpayer for correction should be made in the office of the collector, so that if the taxpayer fails to properly amend and forward same, the collector may take steps to secure the return. (Mim. letter 1160, February 9, 1915.)

In the case of individuals, however, the instructions to collectors state that under these circumstances the amended return will not be required.

RULING. Hereafter, in cases where an individual, a fiduciary or a withholding agent has been found subject to a further tax as a

[1]It is not the general practice to require amended returns from a taxpayer. If an examination is made by a revenue agent and additional tax is to be assessed, the revenue agent prepares the equivalent of an amended return on which the adjusted tax is based, and the taxpayer is informed by the Treasury of the reasons for the additional assessment.

result of the audit of a return in this office, or of an investigation made by a revenue agent, an amended return will not be required. (Mim. letter 1232, June 22, 1915.)

In such cases notice of the proposed additional tax is set forth in the form of a letter from the Commissioner. This procedure has also been extended to corporations.

The foregoing instructions do not cover the procedure to be followed when taxpayers on their own initiative desire to file amended returns. The Treasury prefers that a taxpayer desiring to file an amended return should request permission, stating his reasons. It is obvious that when cases come up for examination those that have attached letters from the Commissioner granting such permission will receive better consideration than those without such permission, because to some extent at least the changes between original and amended returns will have been already passed upon by the Treasury. But the formal refusal by the Treasury to sanction amended returns should not be deemed to be final in meritorious cases. If the formal consent is withheld it would seem to be proper procedure for the taxpayer to prepare corrected returns[2] and file them with his local collector who should not refuse to accept them for transmission to the Commissioner.

The regulations specifically provide for amended returns in certain contingencies. For example, the regulation in regard to losses points out the taxpayer's privilege to file an amended return.

REGULATION. . . . . If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. . . . . (Art. 111.)

RULING. A corporation may submit amended returns for previous years when through wrong accounting practice capital charges have been made to income. An affidavit should be attached, explaining the

[2]When amended returns for 1916 and years prior are filed the form prescribed for the year 1916 should be used.

changes made by such amended returns in the amounts shown on the original return, and explaining why the original returns were not properly prepared and the object of the company in preparing amended returns. Such amended returns will be accepted only when the erroneous charge can be specifically pointed out and the facts proven. The Internal Revenue Bureau reserves the right to penalize for the making of false returns in the past. (C. B. 1, page 234; O. D. 113.)

Amended returns may of course be made for reasons other than incorrect accounting.

Amended returns—community property.—Those taxpayers who have not taken advantage of the decision on community property[3] are still entitiled to file amended returns so as to give effect to the treatment of community property[4] as separate property of husband and wife.

Amended returns barred four years after payment.—Amended returns may be filed for 1917 or subsequent years.

LAW. Section 1316. [Section 3228, Rev. Stat.] All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum.

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

It should be noted that the period begins to run "after payment of such tax, penalty, or sum." Therefore when additional taxes are assessed in respect of the year 1917 or prior, the four-year limitation does not *begin* to run until payment is made.

Amended returns not necessary to adjust minor items.—In cases in which there are only a few items requiring adjust-

[3] C. B. 3, page 309; O. D. 708.
[4] See page 82.

ment, a statement showing the recomputation of tax is sufficient.

If the adjustments show an additional tax, the Commissioner will in due course make an assessment. Where an overpayment is shown, the statement should be attached to either a claim for refund or a claim for credit.

Supplemental returns must be filed by corporations with fiscal years ending in 1921.—Where the tax due under the new law differs from that shown by the returns already filed, supplemental returns should be prepared to show the adjusted tax. The return already filed under the 1918 law will be used as the basis for assessing the tax for that portion of the fiscal year included in the calendar year 1920. The supplemental return, i.e., the return under the 1921 law, will be the basis for the tax applicable to that portion of the fiscal year included in the calendar year 1921.

Tax adjustment when amended returns for 1913-1916 are filed.—When the filing of amended returns results in a refund from or an additional payment to the government, the matter is not finally settled if the returns are for 1916 or prior years. Until December 31, 1916, federal income taxes paid or accrued were an allowable deduction. If net income during 1916 or prior years was greater or less than that shown by the returns, and the tax thereon is readjusted, there will be required a corresponding adjustment of net income in the succeeding year equal to the refund received or additional payment made. If a refund is received, the tax for the following year will be increased. If an additional payment is made, the tax for the following year will be decreased.

This is usually taken care of by setting up a statement showing all adjustments of income on the corrected basis and including the corrected tax of previous years as a deduction in succeeding years.

Payment of tax shown by amended returns—payable when?—Generally speaking, additional taxes shown by an amended return are not payable until they have been assessed by the Commissioner. Aside from those cases arising under T. D. 3220,[5] the procedure is that collectors forward the returns to the Commissioner, and after they have been audited, assessments, if any, are sent to the collector, who in due course demands payment.

Examinations to Ascertain Correctness of Returns

Treasury officers have full power to examine books and records and to require attendance of the necessary persons in the course of examinations to establish the accuracy of income tax returns.

LAW. Section 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

LAW. Section 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provision of this Act. The remedies hereby provided are in

[5] See B. 37-21-1822.

addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions. . . . .

It should be noted that the plenary power of examination extends also to persons, other than the taxpayer, who have knowledge of his income.[6]

The author has frequently been asked by taxpayers: "What shall we do when an inspector calls?" Perhaps taxpayers will have a better understanding of their own obligations if acquainted with the duties of income tax inspectors, as set forth in the regulations. These are, in part, as follows:

Rule 20. The duties of officers of this class are to ascertain and report the names of persons who in their opinion are liable to the income tax and who have failed to make return as required by law; to inquire into income tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns, for the purpose of ascertaining and reporting as to whether the law has been complied with. . . .

In the discharge of their official duties officers of this class, as well as all officers of the Internal Revenue Bureau, in making inquiries and investigations are expected to exercise sound discretion, treat all persons with due courtesy, and, while acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint. (T. D. 1932, January 13, 1914.)

Inspectors usually call upon individual taxpayers without notice. In the case of business concerns appointments convenient to both are made over the telephone. Although the right of inspectors to examine the books and accounts of all taxpayers is unquestioned, the author does not know of an instance when an immediate examination has been insisted upon to the inconvenience of the taxpayer. There should be no trouble in arranging a convenient time.

Taxpayers should furnish the inspector with all information called for, and, by placing at his disposal the original data supporting the returns, the examination will be expedited. In

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[6] *In re Chadwick*, 5 Fed. Cas. 401; Fed. Cas. No. 2570, held that a corporation was not compelled to produce its books upon an inquiry into the income of its stockholders.

case of doubt, too much rather than too little information should be tendered.

RULING. Under section 1305 [Section 1308 of the 1921 law] of the Revenue Act of 1918, it is held that the Commissioner of Internal Revenue is authorized, by any revenue agent or inspector designated by him for that purpose, to examine any of the books, papers, records or memoranda of a bank, bearing upon any matter required to be included in a tax return of one of its depositors or customers. The bank, however, is entitled to satisfy itself in a reasonable manner of the official character and authority of any person making request to examine books or accounts of the bank as an official of the Internal Revenue Bureau. (C. B. 3, page 371; O. D. 609.)

The new law provides that there shall be only one examination each year, unless the taxpayer requests it or the Commissioner notifies the taxpayer in writing that an additional inspection is necessary.[7]

Publicity of Returns and Disclosure of Information

Returns are guarded very carefully. Section 257 provides that they may be inspected by certain parties under certain conditions. Inspection must be made under rules and regulations prescribed by the Secretary of the Treasury and approved by the President.

The Senate attempted to amend section 257, so as to permit either house of Congress to inspect returns. The conferees very wisely eliminated this amendment.

LAW. Section 257. **That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: . . . .**

The following regulation has been recently promulgated with reference to inspection of returns filed under the 1913, 1916, 1917, 1918 and 1921 laws.[8] This regulation has been

[7] Section 1309.

[8] A similar provision of the 1909 law was declared constitutional. (*Flint v. Stone Tracy Co.*, 220 U. S. 107; 55 L. Ed. 389; 31 S. Ct. 342.)

signed by the Secretary of the Treasury and approved by the President.

It should be noted that a written application must be made to inspect a return.

REGULATION. . . . . 1. These regulations deal only with *inspection* of returns, as the statutes expressly require the approval of the President of regulations on this subject. Other uses to which returns may be lawfully put, without action by the President, are not covered by these regulations.

2. The word "corporation" when used alone herein shall, unless otherwise indicated, include corporations, associations, joint-stock companies, and insurance companies. The word "return" when so used shall, unless otherwise indicated, include income and profits tax returns; and also special excise tax returns of corporations filed pursuant to Section 1000, Title X, of each of the Revenue Acts of 1918 and 1921.

3. Written statements filed with the Commissioner of Internal Revenue designed to be supplemental to and to become a part of tax returns shall be subject to the same rules and regulations as to inspection as are the tax returns themselves.

4. Except as hereinafter specifically provided, the Commissioner of Internal Revenue may, in his discretion, upon written application setting forth fully the reasons for the request, grant permission for the inspection of returns in accordance with these regulations. The application will be considered by the Commisisoner and a decision reached by him whether the applicant has met the conditions imposed by these regulations and whether the reasons advanced for permission to inspect are sufficient to permit the inspection. Such written application is not required of the officers and employees of the Treasury Department whose official duties require inspection of a return, or of the Solicitor of Internal Revenue. . . . .

13. When it becomes necessary for the Department to furnish returns or copies thereof for use in legal proceedings, inspection of such returns or copies that necessarily results from such use is permitted.

14. Except as provided in paragraph 13 returns may be inspected only in the office of the Commissioner of Internal Revenue, Washington, District of Columbia.

15. A person who, under these regulations, is permitted to inspect a return may make and take a copy thereof or a memorandum of data contained therein.

16. By Section 3167 R. S., as amended by the Revenue Act of 1918, and reenacted without change in Section 1311 of the Revenue Act of 1921, it is made a misdemeanor for any person to print or

publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures, appearing in any income return, which misdemeanor is punishable by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the Court, and if the offender be an officer or employee of the United States, by dismissal from office or discharge from employment.

17. All former regulations bearing on the subject of inspection of returns are hereby superseded.

18. These regulations shall remain in force until expressly withdrawn or overruled. (T. D. 3277, signed by A. W. Mellon, Secretary of the Treasury, approved by the President, and dated January 24, 1922.)

Method of securing copy of return.—Persons or corporations desiring copies of their own returns may secure them. Representatives of taxpayers holding powers of attorney are legally entitled to inspect or secure copies of returns. Access to corporation returns is permitted stockholders and receivers as a right and to state officers under carefully restricted conditions.[9] Copies of returns are furnished the proper officers and employees of the Treasury, and to the proper officers of a court for use in a trial of any case to which both the United States and the person rendering the return are parties.[10] Otherwise returns are considered "inviolably confidential."[11]

REGULATION. . . . . 2. A copy of an income return may be furnished by the Commissioner of Internal Revenue to the person who made the return or to his duly constituted attorney, or if the person is deceased, to his executor or administrator; or if the entity is in the hands of a receiver, trustee in bankruptcy, guardian, or similar legal custodian, to the receiver, trustee, or other similar custodian upon written application for same, accompanied by satisfactory evidence that the applicant comes within this provision. "The person who made the return," as herein used, refers in the case of an individual return to the individual whose return is desired, and in the case of a return of a corporation, association, joint-stock company, insurance company, or fiduciary to the corporation, association, joint-stock company, or fiduciary, a copy of whose return is desired. A corporation may also designate by proper action of its board of directors the officer or individual to whom a copy of a return made by the corporation may

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[9] See pages 124-125.

[10] Art. 1091.

[11] *Income Tax Primer*, 1918, question 142.

be furnished, and upon sufficient evidence of such action and of the identity of the officer or individual, a copy may be furnished to such person. A copy of a partnership income return will be furnished to the partners only in case all the partners join in the request therefor, it matters not what particular partner or officer of the partnership made the return. If the partnership has been dissolved, the members surviving may be furnished a copy if all the members surviving join in the request. (Art. 1091.)

Inspection of individual returns.—

Regulation. . . . . 5. The return of an individual shall be open to inspection as follows:

(*a*) By the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (*b*) by the person who made the return, or by his duly constituted attorney in fact; (*c*) by the administrator, executor, or trustee of the taxpayer's estate, or by the duly constituted attorney in fact of such administrator, executor, or trustee, where the maker of the return has died; and (*d*) in the discretion of the Commissioner of Internal Revenue, by one of the heirs at law or next of kin of such deceased person upon showing that he has a material interest which will be affected by information contained in the return.

6. A joint return of a husband and wife shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; and (*b*) by either spouse for whom the return was made (or his or her duly constituted attorney in fact or legal representative), upon satisfactory evidence of such relationship being furnished. . . . . (Art. 1090.)

It is well to remember that not even the officers of a state imposing an income tax have been able to secure access to individual returns.

Inspection of partnership returns.—

Regulation. . . . . 7. The return of a partnership shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; and (*b*) by any individual (or his duly constituted attorney in fact or legal representative) who was a member of such partnership during any part of the time covered by the return, upon satisfactory evidence of such fact being furnished. (Art. 1090.)

Inspection of returns of estates and trusts.—

Regulation. . . . . 8. The return of an estate shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection, and by the Solicitor of Internal Revenue; (*b*) by the administrator, executor, or trustee of such estate, or by his duly constituted attorney in fact; and (*c*) by one of the heirs at law or next of kin of the deceased person whose estate is being administered upon a showing of a material interest which will be affected by information contained in the return. . . . . (Art. 1090.)

Beneficiaries are entitled to inspect returns of the estate.

Regulation. . . . . 9. The return of a trust upon which a tax has been determined shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection, and by the Solicitor of Internal Revenue; (*b*) by the trustee or trustees, or the duly constituted attorney in fact of such trustee or trustees; and (*c*) by any individual (or his duly constituted attorney in fact or legal representative) who was a beneficiary under such trust during any part of the time covered by the return, upon satisfactory evidence of such fact being furnished. (Art. 1090.)

Rulings. An original letter with regard to his return written by a decedent to the collector may not be furnished to the attorneys for the estate. A certified or photostatic copy may, however, be given to them provided the executors submit a copy of the letters testamentary issued to them by the court, together with a letter signed by them authorizing the attorneys to receive a copy of the letter in question. (C. B. 3, page 313; O. D. 576.)

The executor of an estate may secure copies of income tax returns filed by the decedent upon submission to the Commissioner of a certified copy of letters testamentary evidencing his appointment as executor. (C. B. 1, page 131; O. D. 355.)

Inspection of corporation returns.—

Regulation. . . . . 10. The return of a corporation shall be open to inspection (a) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (b) upon satisfactory evidence of identity and official position, by the president, vice-president, secretary or treasurer of such corporation or if none, its principal officer; and (c) by a stockholder of such corporation as provided in paragraph 11 hereof. (T. D. 3277; January 24, 1922.)

This provision is new. It would appear that under this article a single partner may inspect the partnership return

and make a copy thereof, although he could not require the Commissioner to supply a copy under article 1091.

Certified copies of returns for use as evidence.—

REGULATION. 1. The original income return of an individual, partnership, corporation, association, joint-stock company, insurance company, or fiduciary, or a copy thereof, may be furnished by the Commissioner of Internal Revenue to a United States attorney for use as evidence before a United States grand jury or in litigation in any court, where the United States is interested in the result, or for use in the preparation for such litigation, or to an attorney connected with the Department of Justice designated to handle such matters, upon written request of the Attorney General, the Assistant to the Attorney General, or an Assistant Attorney General. When an income return or copy thereof is thus furnished, it must be limited in use to the purpose for which it is furnished and is under no conditions to be made public except where publicity necessarily results from such use. In case the original return is necessary, it shall be placed in evidence by the Commissioner of Internal Revenue or by some other officer or employee of the Internal Revenue Bureau designated by the Commissioner for that purpose, and after it has been placed in evidence it shall be returned to the files in the office of the Commissioner in Washington. An original return will be furnished only in exceptional cases, and then only when it is made to appear that the ends of justice may otherwise be defeated. Neither the original nor a copy of an income return, desired for use in litigation in court where the United States Government is not interested in the result and where such use might result in making public the information contained therein, will be furnished, except as otherwise provided in the next succeeding paragraph.[12] . . . . (Art. 1091.)

RULING. Ownership certificates are income returns within the meaning of section 3167, Revised Statutes, as amended. Since they are filed as a result of income tax laws for the purpose of being used in connection with income tax returns they are to be treated as such under the regulations governing the furnishing of copies. (C. B. 1, page 262; O. 879.)

Inspection of returns of various federal agencies.—

REGULATION. . . . . . 12. When the head of an executive department (other than the Treasury Department) or of any other

[12] [Former Procedure] This is an amendment of section 1, paragraph 1, of T. D. 2962. Formerly the Attorney General had to make a written request for an original return. Under the present Treasury decision, the Attorney General, the Assistant to the Attorney General, or an Assistant Attorney General may request an original return.

United States Government establishment, desires to inspect or to have some other officer or employee of his branch of the service inspect a return in connection with some matter officially before him, the inspection may, in the discretion of the Secretary of the Treasury, be permitted upon written application to him by the head of such executive department or other Government establishment. The application must be signed by such head and must show in detail why the inspection is desired, the name and address of the taxpayer who made the return, and the name and official designation of the one it is desired shall inspect the return. When the head of a bureau or office in the Treasury Department, not a part of the Internal Revenue Bureau, desires to inspect a return in connection with some matter officially before him, other than an income, profits tax or corporation excise tax matter, the inspection may, in the discretion of the Secretary, be permitted upon written application to him by the head of such bureau or office showing in detail why the inspection is desired. The reasons submitted for permission to inspect as provided in this paragraph shall be considered by the Secretary and a decision reached by him whether the reasons are sufficient to permit the inspection. (T. D. 3277, January 24, 1922.)

It is questionable whether "the head of an executive department (other than the Treasury Department) or of any other United States Government establishment," may legally inspect tax returns filed under any of the laws.

Inspection of corporation returns by officers of states imposing income taxes.—

LAW. Section 257. . . . . *Provided,* **That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: . . . .**

Federal returns are apparently available to states which impose income taxes on corporations irrespective of whether they impose a similar tax on individuals as well.[13] The permission, however, extends merely to corporation returns. Individual returns are not open to inspection by state officers, although efforts have been made to change the law so as to make them so.

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[13] [Former Procedure] The 1916 law [section 14 (b)] permitted examination when the state imposed a "general income tax."

The following regulations set forth the procedure to follow to secure permission to examine such returns:

REGULATION. 1. The proper officers of a State imposing an income tax are entitled as of right upon the request of its governor to have access to the income and profits tax returns of a corporation, association, joint-stock company, or insurance company, or to an abstract thereof, showing its name and income. Proper officers in this connection are only those officers of the State who are charged with the enforcement of the State income-tax law and who are to use the information gained by the access only in connection with such enforcement.

2. The request or application of the governor must be in writing, signed by him under the seal of his State, and must show:

(*a*) That the State imposes an income tax.

(*b*) The name and address of the corporation, association, joint-stock company, or insurance company making the returns to which access is desired.

(*c*) Why access is desired.

(*d*) The names and official positions of the officers designated to have the access.

(*e*) That such designated officers are charged with the enforcement of the State income-tax law.

(*f*) That the information to be gained by the access is to be used only in connection with such enforcement.

3. The request or application of the governor may be addressed either to the Secretary of the Treasury or to the Commissioner of Internal Revenue, but should be transmitted to the Commissioner, who will set a convenient time for the access to the returns (or to an abstract thereof as he may determine).

4. Access shall be given only in the office of the Commissioner of Internal Revenue in Washington.

5. The officers designated by the governor will not be permitted to name another person or persons to examine the returns (or abstracts) for them.

6. The officers designated will be given access only to the returns of those corporations, associations, joint-stock companies, or insurance companies organized or doing business in their State.

7. The officers designated may have access to lists furnished to supplement and become a part of the returns to which they are given access.

8. The proper officers, as defined in paragraph 1, may have access to the capital stock tax returns filed under the provisions of section 1000 of the revenue act of 1921 under the same conditions prescribed in the preceding paragraph for access to the income and profits tax returns of corporations, associations, joint-stock companies, and in-

surance companies. This right does not extend to the examination of capital stock tax returns filed pursuant to prior acts of Congress, except the revenue act of 1918. (Art. 1092.)

This article incorporates in the regulations, T. D. 2962 which has been extended to the Revenue Act of 1921 (see B. I-6-80; T. D. 3273).

Under this regulation access to the returns is limited to officers who are "charged with the enforcement of the state income tax law" and are to use the information only for purposes of such enforcement.

Inspection of corporation returns by stockholder.—The law sets forth the exact conditions which shall govern the inspection of a corporate return by a stockholder.[14]

LAW. Section 257. . . . . *Provided further,* That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both. . . . .

The privilege granted by the above section is an express exception in the law. It is personal to the stockholder and may not be delegated. It should not be inferred from the phrase "provided by law" that a stockholder could use the figures obtained from an examination of the corporation's return on file in the Commissioner's office in a lawsuit which he might bring against the corporation. A stockholder who has acquired shares merely for the purpose of inspecting the returns of the corporation is not a bona fide stockholder.

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[14] [Former Procedure] Before the passage of the 1918 law, the Treasury regulations permitted inspection under certain conditions. (T. D. 2016, April 18, 1914).

REGULATION. A bona fide stockholder of record owning 1 per cent or more of the outstanding stock of a corporation shall be entitled as of right, upon making request of the Commissioner of Internal Revenue, to examine the annual income returns of such corporation and of its subsidiaries made under Titles II and III of the revenue acts of 1918 or 1921, and all returns of corporations filed for purposes of the tax imposed by section 1000, Title X, of said acts. His request for permission to examine such returns must be made in writing and must be in the form of an affidavit showing his address, the name of the corporation, the period of time covered by the return he desires to inspect, the amount of the corporation's outstanding capital stock, the number of shares owned by him, the date when he acquired them, and whether he has the beneficial as well as the record title to such shares. It must also show that he has not acquired his shares for the purpose of the examination of the income returns of the corporation. If he has acquired them for this purpose he is not a bona fide stockholder within the meaning of the statute. The application must be supported by satisfactory evidence showing that the applicant is a bona fide stockholder of record of the required amount of stock of the corporation. The supporting evidence may be partly in the form of a certificate signed by the president or vice president of the corporation, and countersigned by the secretary under the corporate seal. Upon being satisfied from the evidence presented that the applicant has fully met these conditions the commissioner will grant the permission to examine the returns and set a convenient time for the examination in the office of the commissioner. This privilege is personal and will be granted only to the stockholder, who can not delegate it to another. (Art. 1093.)

RULING. A "stockholders' protective committee," to which deposited stock has been transferred for the purpose of safeguarding the interests of the minority stockholders, is not considered a bona fide stockholder within the meaning of section 257 of the Revenue Act of 1918. (C. B. 1, page 133; O. D. 273.)

When it is desired to inspect returns of years prior to 1918, the procedure laid down in T. D. 3277 must be followed.

Unofficial disclosure of information forbidden.—During 1921, several employees and ex-employees of the Treasury were indicted for giving out information about tax returns. Considering the opportunities for graft and the large number of employees, there are very few violations. "Leaks" are occasionally heard of. Taxpayers, as well as those who are

practicing before the Treasury, should notify the officials at once if it is believed that any confidential information has been illegally disclosed. It is their duty to do so.

LAW. Section 1311. [Section 3167, Rev. Stat.] **It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income reurn, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.**

Referring to sections 3152, 3167, 3173 and 3176 of the Revised Statutes, a Treasury decision states:

RULING. Reading these provisions of law together, it is evident that any collector, deputy collector, agent, clerk, or other officer or employee of the Bureau of Internal Revenue, including internal revenue agents, who divulges or makes known in any manner whatsoever not provided by law the amount or source of income, profits, losses, expenditures, or any particulars thereof set forth or disclosed in any income return made by any taxpayer, or by a collector or deputy collector, or by the Commissioner of Internal Revenue, or who permits any income return or copy thereof, or any book containing any abstract or particulars thereof, to be seen or examined by any person, except as provided by law, or who prints or publishes in any manner whatever, not provided by law, any income return or any part thereof, or source of income, profits, losses, or expenditures appearing in any income return, is guilty of a misdemeanor and subject to a fine not exceeding $1,000 or to imprisonment not exceeding one year, or both, at the discretion of the court, and if he be an officer or employee of the United States, to be dismissed from office or discharged from employment. (T. D. 2903, July 30, 1919.)

List of taxpayers to be posted.—The law requires that the names and addresses of taxpayers be thrown open to public inspection.

LAW. Section 257. . . . . The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

The regulations are silent as to the foregoing section of the law. Since the words "shall" and "in each year" are used in the law, the posting of the lists is obligatory.

RULING. In accordance with section 257 of the Revenue Act of 1918 lists containing the names and post-office addresses of individuals making income tax returns to collectors are posted for public inspection in the public corridors of collectors' offices and post-offices. Persons will not be allowed to enter the workrooms of collectors' offices either outside or during office hours for the purpose of making copies of such lists. (C. B. 2, page 259; O. D. 531.)

Publication of statistics.—The Senate attempted to continue in the 1921 law the provision of the 1918 law which required taxpayers to report for statistical purposes tax-exempt securities.[15] It was also proposed to require the Commissioner to make a report to Congress which would enable it to know the amount of income escaping through tax-exempt securities. The conferees eliminated these proposals. The Commissioner, notwithstanding that these proposals were not adopted, is authorized under his broad powers to collect this information.

The law does, however, require the Commissioner to publish statistics. In this respect it is the same as the 1918 law.

LAW. Section 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits-tax laws, including classifications of tax-payers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

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[15] Section 213 (b-4).

Regulation. The Commissioner will publish annually a volume of statistics of income, showing, among other things, the distribution of incomes between corporations and individuals and by States, by classes and by occupations. (Art. 1101.)

Compilations, giving very full details regarding statistics of income for the calendar years 1916 and 1917, were issued some time ago. In November, 1920, a summary of the statistics gathered from the 1918 returns was made public. During the year 1921, a preliminary report of statistics for the fiscal year 1919 was issued. A more detailed report was issued during February, 1922.

CHAPTER VI

PENALTIES

Before and after the filing of returns, taxpayers may inadvertently or otherwise render themselves liable to penalties for negligent or fraudulent returns, insufficient or delayed payments of taxes, or other shortcomings. These matters are discussed in this chapter.

Penalties and Procedure in Cases of Delinquency

The following is a synopsis of penalties for failure to file returns and for the filing of false or fraudulent returns, as well as other penalties imposed by the Revenue Act of 1921. Interest at a reasonable rate can hardly be called a penalty, but as interest rates vary considerably, and as interest runs from various dates, the synopsis includes all interest liability.

SYNOPSIS OF INTEREST REQUIREMENTS AND PENALTIES

ABSTRACT OF REVENUE ACT OF 1921

Section of Act		*Penalty*
	UNDERSTATEMENT OF AMOUNT OF TAX	
250 (b)	If not due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, or fraud.	½ of 1% per month from the time the tax was due (or if paid on the instalment basis, on the deficiency of each instalment from the time the instalment was due) to the extent same is not covered by any credits due to the taxpayer under section 252.

250 (b)	If due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud.	5% of the total amount of the deficiency in the tax, and interest at the rate of 1% per month on the amount of such deficiency from the time it was due (or if paid on the instalment basis, on the amount of the deficiency in each instalment from the time the instalment was due).
250 (b)	If any part of the deficiency is due to fraud with intent to evade tax.	50% of the total amount of the deficiency in the tax in lieu of penalty provided by section 1311 (R. S. 3176) but in addition to specific penalties (see section 253).
1311 (R. S. 3176)	False or fraudulent return or list willfully made.	50% of amount of tax in addition to specific penalties (but not in addition to the 50% penalty in preceding section). (See section 253.)
253	Willful attempt to evade tax (applies to taxpayer, officers and employees).	Maximum fine $10,000, or maximum imprisonment one year, or both, with costs, in addition to ad valorem penalties. [See sections 250 (b) and 1311.]

FAILURE TO FILE RETURN OF INFORMATION

253	Failure to file when due.	Maximum fine $1,000; in addition to ad valorem penalty. (See section 1311 below.)
253	Refusal willfully to make return or willful attempt in any manner to defeat or evade the tax.	Maximum fine $10,000, or maximum imprisonment one year, or both, with costs, in addition to ad valorem penalty. (See section 1311 below.)
1311 (R. S. 3176)	Failure to file when due (unless shown to be due to reasonable cause).	25% of amount of tax in addition to specific penalty. (See section 253 above.)

1408........ (1918 act)	Failure to file true and correct copy of any government contract on request.	$1,000 fine, one year imprisonment, or both.

Failure to Pay Tax When Due

250 (a)....	When extension is granted for filing final returns.	½% per month interest on amount of deficiency, if any, in initial instalments.
250 (a)....	When instalment is not paid when due.	Entire tax becomes due and payable on notice and demand; 5% on amount due and unpaid; 1% per month interest in addition to specific penalty. (See section 253.)
250 (e)....	Failure to pay when due, unless covered by a *bona fide* claim for abatement which was filed within ten days after notice and demand by the collector, and without the taxpayer having had the benefit of the provisions of subdivision (d) of this section, in which case the only penalty is ½ of 1% per month except claims for inventory losses (under 1918 act) interest on which is 1% per month. [See sections 214 (a-12) and 234 (a-14), 1918 act.] (This applies to taxes under 1917, 1918 and 1921 acts.)	5% on amount due, 1% per month interest in addition to specific penalty. (See section 253.)
250 (f)....	When extension is granted for paying deficiency in tax under 1917, 1918 or 1921 act.	Within period of 18 months from passage of 1921 act (November 23, 1921), extension may be granted for paying deficiency upon cause shown. From date of extension until payment of interest at rate of ⅔ of 1% per month, except where such interest provided by law is in excess thereof.

250 (f)	When deficiency or any part thereof is not paid in accordance with the terms of extension granted.	5% of the amount of the deficiency, and interest on the deficiency at the rate of 1% per month from the time it became payable, in accordance with the terms of the extension, in lieu of other penalties and interest that would attach under the law.
250 (g)	When, after Commissioner has taken action under this section, a taxpayer violated or attempts to violate the provisions thereof; also when an alien violates or attempts to violate the provisions of this section relating to the securing of certificate prior to departure from the United States (with respect to taxes under 1917, 1918 and 1921 acts).	25% of the total amount of the tax or the deficiency in the tax, together with interest at the rate of 1% per month from the time the tax became due, in addition to all other penalties.
253	Failure to pay or collect tax at time required.	Maximum fine $1,000 in addition to ad valorem penalty. (See section 250.)
253	Willful refusal to pay tax when required (applies to taxpayer, officers and employees).	Maximum fine $10,000, maximum imprisonment one year, or both, with costs, in addition to ad valorem penalty. (See section 250.)

Failure to make return—collector to supply deficiency.—

LAW. Section 1311. [Section 3176, Rev. Stat.] **If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any re-**

turn or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes. . . .

Accordingly, in cases where the collector or Commissioner makes a return, the amount of tax determined under the substitute return is payable upon notice and demand.[1]

Penalties for failure to make return.—There are two penalties for failure to file a return, viz., a specific fine and a percentage (ad valorem) penalty. The former can be imposed only by the courts, while the latter may be assessed by the Commissioner.

Penalty of fine.[2]—The 1921 law, as compared with the 1918 law, did not make any change in the following provision:

Law. Section 253. **That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000.**[3] . . .

Penalty of 25 per cent additional tax.[4]—Aside from changing the section number from 1317 to 1311, the 1921 law does not make any change in the following provision of the 1918 law:

Law. Section 1311. [Section 3176, Rev. Stat.] . . . . **In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it**

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[1] See Chapter VIII.

[2] The above penalties are for cases where the failure to file return or pay tax is not "wilful." For penalties in cases of wilful refusal to file return or pay tax, see page 137.

[3] **[Former Procedure]** A minimum fine of $20 was provided by section 18 of the 1916 law.

[4] **[Former Procedure]** Fifty per cent under 1916 law (section 16).

was due to a reasonable cause and not to willful neglect,[5] no such addition shall be made to the tax.[6]. . . .

This is broader than the earlier law, in that it is now necessary only to show that failure was "due to a reasonable cause and not to willful neglect." Before the Solicitor issued Law Opinion 1060, it was considered necessary in addition that the return be filed "voluntarily and without notice from the collector." Such voluntary filing, however, is obviously the best possible evidence that the failure to file was due to a reasonable cause and not to wilful neglect. Certainly the taxpayer seeking relief from a penalty is in a much stronger position if his return has been voluntarily filed. The regulations in the past have prescribed that the penalty of increased tax shall be remitted only if the cause "is found to be reasonable." It can be assumed that any cause short of fraud or wilful neglect will be deemed to be reasonable.

REGULATION. . . . . If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return in the prescribed time, then the delay is due to "reasonable cause." . . . . (Art. 1004.)

RULING. Where the attendant and surrounding circumstances have a tendency to cast doubt and suspicion upon a taxpayer, a plea

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[5] **[Former Procedure]** Under the earlier law this remission of penalty was granted only when a return was filed "voluntarily and without notice from the collector." (Section 16, section 3176, Rev. Stat.)

During 1921 the Solicitor made a more liberal interpretation of this section of the law. The 50 per cent penalty is imposed only where there has been "a refusal or inexcusable neglect" to file a return.

RULING. "A mere failure to file a return as required by and within the time prescribed in the Act of October 3, 1913, does not of itself constitute a 'refusal or neglect' to file such return within the meaning of section 3176 R. S., as amended by the Act of October 3, 1913.

"The Commissioner is authorized and required to add the 50 per cent to the tax provided for in section 3176, R. S., as amended by the Act of October 3, 1913, only where there has been a refusal or inexcusable neglect on the part of the taxpayer to file the return within the time prescribed by law." (C. B. 4, page 318; Digest L. O. 1060.)

[6] In the case of this 25 per cent penalty as well as the 50 per cent penalty for false or fraudulent list, "The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax." (Law, section 1311, section 3176, Rev. Stat.)

of mere ignorance is not sufficient to constitute a reasonable cause for failure to make and file a return within the time prescribed by law for the purpose of being relieved of the penalty. (C. B. 1, page 247; O. 818.)

The above quoted regulation further declares that, to avoid the penalty, the taxpayer should attach to the return an affidavit showing the facts alleged as a reasonable cause for failure to make the return in due time. The Commissioner passes upon the validity of the showing and without his consent no remission is made. Relief from the ad valorem penalty does not necessarily relieve the taxpayer from liability to the specific fine.[7]

RULING. (1) The ad valorem penalties for fraudulent returns should be assessed against withholding agents under the income tax provisions of the law.

(2) The ad valorem penalties for delinquent returns should be assessed against withholding agents under the income tax provisions of the law, except that if the tax required to be withheld is paid by the recipient of the income, no such penalty should be collected from the withholding agent unless his delinquency was fraudulent and for the purpose of evading payment. . . . . (C. B. 2, page 229; S. 1334.)

In answering the contention that ad valorem penalties did not apply to withholding agents, the solicitor stated that:

I can see no good reason for distinguishing between taxpayers and withholding agents as regards the assessment of the ad valorem penalties for delinquent or fraudulent returns.

The 50 per cent penalty.—The 50 per cent penalty applies only to false or fraudulent returns. This penalty also becomes a part of the tax and may be assessed by the Commissioner.

LAW. Section 1311. [Section 3176 Rev. Stat.] . . . . **In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount. . . . .**

Prior to 1918, section 3176 of the Revised Statutes provided for a penalty of 100 per cent. In the 1918 law the penalty was reduced to 50 per cent.

Section 250 (b) of the new law reads as follows:

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[7] See page 132.

LAW. Section 250. . . . . (b) . . . . **If any part of the deficiency is due to fraud with intent to evade tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector. . . . .**

The distinction between the penalties imposed under section 3176, Revised Statutes, and section 250 (b), is that under the former the 50 per cent penalty is computed on the full amount of the tax correctly payable (both original and additional assessments), whereas under the latter section the penalty is computed only on the deficiency of tax, i.e., the amount of tax under-reported on the false or fraudulent return.

In view of the notice by the Commissioner that "tax slackers" are to be severely dealt with, it should be noted that in addition to all other penalties there will be added to the deficiency in tax an additional 50 per cent thereof. Determination of what constitutes a false return will depend on the circumstances of each case, but it is reasonable to suppose that the wide publicity during the last several years given to all income tax matters will put the burden of proof upon every citizen who makes an understatement, and when it is found that there has been a failure to report income it will be much more difficult than heretofore to claim ignorance of the law.

RULINGS. "Understatement" as used in section 250 (b) has particular reference to the understatement of the amount of the tax in the return. This is true whether such understatement resulted from the false or fraudulent computation of the tax or from false or fraudulent misstatements or omissions of items of income or misstatements of items of deduction or from other false or fraudulent entries or omissions.

Section 250 (b), providing for the addition as part of the tax 50 per centum of the amount of the deficiency, and not section 3176, R. S., as amended by the revenue act of 1918, is applicable to income and profits tax matters arising under the revenue act of 1918, where there is an understatement of the amount of the tax in the return

and the understatement resulted from fraud with intent to evade the tax. In all other cases of false or fraudulent returns willfully made in matters arising under the revenue act of 1918, section 3176, Revised Statutes, as amended by that act, is applicable. (C. B. 2, page 232; O. 1008.)

A taxpayer who filed a return of income which did not include profit on the sale of certain corporate stock and in reply to an inquiry by an examining officer stated that he had not made any money on outside investments during the year, but in reply to a direct inquiry in regard to the sale of the stock, based on confidential information, admitted the sale, but made no explanation of his failure to include the profit on the sale in his return for the taxable year, is held to have filed a false and fraudulent return for the purpose of evading taxation and the 100 per cent additional tax should be assessed. (1913 Act.) (C. B. 1, page 248; S. 926.)

In *Levy v. United States*,[8] the defendant made an amended income and excess profits tax return which was proven to be false. It was urged that the offense related to an "amended" return and no return of that character was known to the criminal law. The court held that while amended returns may not be prescribed by statute, they nevertheless fall within its contemplation.

In *United States v. Rachmil*,[9] it was held, in an indictment for conspiracy to evade payment of an income tax, the preparation, signing, and acknowledgment of a false return, alleged as overt acts, would not constitute an attempt to evade payment of the tax. However, the filing of the false return with the collector would be such an attempt.

Rulings. Where an income tax return under the Revenue Act of 1916, or an income or excess profits tax return under the Revenue Act of 1917, has been found to be false and fraudulent and the additional tax has been assessed and paid at a time when the grounds for asserting the 100 per cent fraud penalty under section 3176 R. S., as amended by the Revenue Act of 1916, were fully known to the department, no fraud penalty may be thereafter assessed; where under such circumstances the additional tax has been assessed but not paid or paid but not assessed, the fraud penalty may still be assessed.

The rule under the Revenue Act of 1918, however, is different. The 50 per cent fraud penalty under section 250 (b) thereof may be

[8] 271 Fed. 942.
[9] 270 Fed. 869.

subsequently assessed although the additional tax has been both assessed and paid after the discovery of the fraud.

Under all three of these Acts, if the additional tax has been assessed or paid, or assessed and paid prior to discovery of the fraud, the penalty may be assessed at any time after the discovery and within the statutory period for assessment of taxes. . . . . (C. B. 3, page 290; Sol. Op. 52.)

. . . . Taxes may be collected by suit, whether assessed or not, but this is not true with respect to ad valorem penalties which can not be collected by suit without first having been assessed; furthermore even though they have been assessed they may not be collected by suit after five years from the time they accrued.

A waiver by a taxpayer of his rights as to the limitation of assessment of taxes does not carry with it a similar waiver as to the assessment of ad valorem penalties. (C. B. 3, page 295; Sol. Op. 60.) .

The foregoing ruling was made for a specific case in which the taxpayer had filed in 1918 amended returns for the years 1909 to 1916, inclusive. Under the amended returns the net income was shown to be much larger than was originally reported. The Treasury held that, inasmuch as the books clearly reflected the correct net income and the original returns did not, there was evidence of fraud. Furthermore it was held that the real purpose of filing the amended returns was to secure a large invested capital for 1917, which had been reduced by various understatements in original returns.

Penalty for wilful refusal to make return or attempt to evade—fine or imprisonment.—The 1921 law as compared with the 1918 law does not make any change in the following specific penalty:

LAW. Section 253. . . . . Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000[10] or imprisoned for not more than one year, or both, together with the costs of prosecution.

[10] [Former Procedure] Under the earlier law the fine applying to individuals was restricted to $2,000 (1917 law, section 18).

REGULATION. . . . . If the failure is willful, however, or an attempt is made to defeat or evade the tax, the offender is liable to imprisonment and to a fine of not more than $10,000 and costs. See also the Act of July 5, 1884. In addition to these specific penalties ad valorem penalties are imposed in various cases. An ad valorem penalty is assessed and collected as a part of the tax, while a specific penalty is recoverable only by suit. . . . . (Art. 1055. Reg. 45, Art. 1041.)

RULINGS. The giving of instructions or advice with the purpose and intent of inducing persons liable to make income returns or pay income tax to refrain from making such returns or paying such tax is an attempt to defeat the tax within the meaning of the statute, and those giving such instructions or advice are amenable thereto. (C. B. 1, page 259; S. 931.)

If a citizen about to leave the United States willfully refuses to pay such tax as is properly due, he may be arrested and detained for the purpose of facing prosecution criminally for a violation of section 253 of the Revenue Act of 1918. Furthermore, the district courts of the United States, at the instance of the United States, are vested with jurisdiction to make and issue writs and orders of injunction and ne exeat republica and such orders and process as may be necessary or appropriate for the enforcement of the provisions of the Revenue Act of 1918. (Sec. 1318.) With respect to these provisions a citizen departing is in no different position from a citizen continuing in the United States—the Act being enforceable alike against taxpayers continuing in the United States and taxpayers departing from the United States. (C. B. 1, page 260; O. D. 168.)

The foregoing relates to tax which is due and should not be confused with the provisions of section 250 (g).[11]

Imperfect returns not acceptable.—Notwithstanding the requirement of the Treasury that taxpayers must secure the approval of the Commissioner to file tentative returns, the following would seem to permit the filing of tentative returns without permission:

REGULATION. . . . . Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions

[11] See page VIII.

therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form. (Art. 407.)

The author knows of a case where a tentative return was filed without permission, due to a misunderstanding. The estimated amount of tax paid was considerably in excess of that shown by the final return which was filed about a month later.

Notwithstanding the fact that the Commissioner knew all the facts and knew absolutely that there was no evidence of fraud, and also had received an excessive payment for the first instalment, a penalty of about $30,000 was assessed against the taxpayer. The employees of the Treasury then had the audacity to offer to compromise the penalty for about $5,000!

The author is of the opinion that article 407 places a correct interpretation upon the law. If a taxpayer is able to file only a tentative return on the due date, he has filed a return within the meaning of the law. A complete return should be filed as soon as possible. Of course taxpayers are not excused from the obligation to request extensions of time, which are freely granted in all meritorious cases. The foregoing discussion concerns taxpayers who without negligence have failed to secure formal extensions of time.

Penalties for Understatements and for Failure or Delay of Payment

Under both the 1918 and 1921 laws, if it appears that an understatement of the amount of tax due has been made in good faith, there shall be no penalty because of such understatement, but if due to negligence, there shall be a penalty of 5 per cent added to the additional tax, plus interest at the rate of 12 per cent per annum.

The 1921 law does not make any material change in the provision of the 1918 law regarding understatements of tax

liability.[12] The phrase, "intentional disregard of authorized rules and regulations with knowledge thereof," constitutes the only change of any importance. This phrase previously appeared in article 1005 of Regulations 45.

LAW. Section 250. . . . . (b) . . . . **If any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector. . . .**

It is therefore of importance to taxpayers that, if an additional assessment is made, care be taken to produce evidence that there was no negligence involved, but that on the contrary the return was made in good faith and not due to any fault of the taxpayer.

REGULATION. . . . . Negligence is the absence of reasonable care under the circumstances. . . . . (Art. 1005.)

Of course, if the instructions on the return are contrary to the law, it is not necessary to follow them. It is good practice, however, to indicate how and why the instructions were not followed. This is confirmed by the Committee on Appeals and Review.

RULING. Held, that the 5 per cent penalty for negligence should not attach in any case where a complete disclosure of all the facts is made by the taxpayer in the return so that the Department can make an assessment of additional tax if it desires to do so. (C. B. 4, page 322; A. R. M. 105.)

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[12] **[Former Procedure]** The 1918 law reads as follows:

LAW. Section 250. . . . . (b) . . . . . if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. If the understatement is due to negligence on the part of the taxpayer, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency, plus interest at the rate of 1 per centum per month on the amount of the deficiency of each installment from the time the installment was due. . . .

The foregoing was a case where appreciation was included in invested capital.

The following ruling of the Committee is also of interest:

RULING. The penalty for negligence should not be asserted against a corporation where the amount of a contribution to the Red Cross and other similar war works was specifically and separately listed in the schedule of general expenses supporting item 12 in its return for 1918. (C. B. 4, page 322; A. R. R. 360.)

The detailed opinion stated that:

There was no specific instruction on the return form dealing with contributions to the Red Cross and other similar war works, and it is a known fact that many lawyers and tax consultants of ability were of the opinion, and so advised their clients, that contributions to these objects under conditions that existed in 1918 when the United States was at war, were legitimate and proper deductions in determining net income, not of course as charitable contributions under section 214 (a) 11 but as ordinary and necessary expenses of business. That the Bureau itself had not made up its mind on this question is clearly indicated by the fact that the question was submitted to the Attorney General for an opinion which at the date of filing the return had not been rendered.

Any interest paid under section 250 should be charged to an expense account as the same is a deductible item.

Penalty for understated tax.—If the mistake is one of which an average reasonable man might be capable, the 5 per cent penalty will not be imposed. It is obvious that the penalty will not be imposed when arithmetical or other errors have been made, provided only that they are such errors as the average man may make. The honest taxpayer can point out in his defense many conflicting and ambiguous regulations.

In view of the complexities and ambiguities of the law, which are recognized by the Treasury itself, no reasonably careful person need fear this penalty. Of course, if a mistake results in a very large understatement of the tax, the whole burden of proof is placed upon the taxpayer to show that he was not on notice that a mistake had probably been made, because there are available methods of approximating the amount of tax due upon a given amount of net income.

The Treasury has imposed penalties when the returns rendered were incorrect, interpreting "incorrect" to mean "incorrect, misleading, false and fraudulent" in view of the facts in particular cases.

RULINGS. "Negligence on the part of the taxpayer, but without intent to defraud" is presumed to exist in every case in which a deduction has been made or income has been omitted in direct conflict with the specific provisions of the law and regulations, but is not presumed to exist if the understatement may be ascribed to an error of judgment as to some matter not so concluded. . . .

. . . . This section [250 (b)] places upon the taxpayer the duty of knowing and understanding such parts of the regulations as are applicable to the submission of his return. This requirement should not be carried to the extent of expecting the judgment of the taxpayer on questions involving judgment to concur exactly with the judgment of representatives at the Bureau. If the understatement is due to writing off more depreciation than is proper, in the judgment of representatives of the Bureau, or the deduction of salaries which are excessive, or similar approximations, then negligence can not be imputed to the taxpayer, unless the position taken is so unreasonable as to indicate bad faith. . . . (C. B. 2, page 231; A. R. M. 23.)

Where, through fraud with intent to evade tax, an understatement of the amount of the tax in an income tax return results, the understatement is false or fraudulent and the 50 per cent of the whole amount of the deficiency is required to be added to the tax. The 5 per cent penalty provided for understatements due to negligence has no application to any part of the deficiency in such a case. (C. B. 2, page 233; O. 1028.)

If a taxpayer in preparing his tax return for 1920 omitted from gross income the gain derived from the sale of capital assets, and failed to make a full disclosure of the facts pertaining to the transaction, the Bureau holds he is guilty of negligence or fraud, as the case may be, for making the understatement.

Collectors should so far as possible expedite the examination of the returns as filed to discover those cases in which the taxpayer omitted from gross income the gain derived from the sale of capital assets and made a full disclosure. If a full disclosure was made, negligence will not be imputed to the taxpayer. These returns should be reported to the Commissioner on Form 23-A in the usual manner prior to the serving of notice and demand. After the Commissioner has assessed the tax on the basis of the collectors' lists, the collectors shall immediately serve, upon Form 17, notice and demand for the additional tax due, and after the ten-day period proceed to collect the

tax, plus interest and the penalty for delinquency, as provided for in section 250 (e) of the Revenue Act of 1918, by distraint if necessary. (C. B. 4, page 72; Mim. 2791.)

No penalty when understatement is made in good faith.—If claim for abatement is made and denied,[13] interest at the rate of 6 per cent per annum is charged from the date originally fixed for payment of the additional assessment on such part of the claim as has been denied. The interest charge at the rate of 6 per cent (instead of 12 per cent) depends upon whether or not the claim for abatement was "bona fide."[14]

Taxpayers who make claims in good faith may confidently rely upon the Commissioner to accord to them the benefit of the 6 per cent rate.[15]

Notice from collector of alleged understatement.—Section 250 (b) of the 1918 and 1921 laws and the usual procedure which governs the examination of returns by inspectors from the Commissioner's office in Washington, are supplemented by the provision of the law which gives to local collectors the right to question the accuracy of returns.

LAW. Section 228. **That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly.[16] Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.**

It is confusing to the average taxpayer to have his returns questioned from two different sources. In view of the right of appeal to the Commissioner in any event, if the collector

[13] Under the 1921 law claims for abatement may be filed only in a few instances. See page IX.

[14] Section 250 (e).

[15] **[Former Procedure]** Prior to the 1918 law the rate was 12 per cent per annum.

[16] See page 135.

gives notice of intention to increase an assessment, taxpayers should appeal at once to the Commissioner and follow the procedure outlined in this chapter.

REGULATION. If a collector has reason to believe that the amount of any income is understated in a return, he may on his own initiative take up the matter with the taxpayer and upon becoming satisfied that the amount was understated may increase it accordingly, subject to the right of the taxpayer to appeal to the Commissioner. The Commissioner, however, without the intervention of the collector may exercise original jurisdiction in cases of understatements or other errors in returns, in which event sections 250 and 1300 of the statute and section 3176 of the Revised Statutes, as amended by section 1311 of the statute, are applicable instead of section 228. . . . . (Art. 451.)

Penalties for failure or delay in payment.—

SPECIFIC PENALTY.—

LAW. Section 253. **That any individual, corporation, or partnership required under this title to pay . . . . any tax, ... who fails to pay . . . . such tax, ... shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay . . . . such tax, ... at the time or times required under this title, ... shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.**

The specific penalties mentioned in the foregoing section of the law, that is, those of not more than $10,000, are collectible only by suit. What are known as ad valorem penalties, such as the 25 per cent and 50 per cent penalties, are assessed and collected as a part of the tax and increase the tax accordingly.[17]

NO INTEREST ON PENALTIES.—The interest charge of 1 per cent a month imposed upon taxes overdue applies only to the amount of tax, not to any specific penalties which may be imposed.

PENALTY OF PERCENTAGE AND INTEREST.—

LAW. Section 250. . . . . **(e) If any tax remains unpaid after**

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[17] See page 174.

the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided,* That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected. . . . .

The circumstances in which penalty interest is collected are set forth in the following regulation:

Regulation. Where the time for the payment of any installment of the tax is postponed at the request of the taxpayer, interest at the rate of 6 per cent per annum is added from the original due date until paid. Except in the case of estates of insane, deceased, or insolvent persons, if any tax remains due and unpaid for 10 days after notice and demand by the collector (in the case of the first installment the instructions printed on the return and the taxpayer's computation of the tax on the return constitute notice and demand) there shall be added as part of the tax 5 per cent of the amount due but unpaid, plus interest at the rate of 12 per cent per annum from the due date, except that the interest on any amount which is the subject of a bona fide claim in abatement filed within 10 days (where the taxpayer has not had the benefit of the notice and the 30-day period for filing an appeal as provided in sec. 250 (d) and art. 1006) shall be at the rate of 6 per cent per annum and the 5 per cent penalty shall not be added. Upon receipt of notice of rejection of claim in abatement (or so much thereof as is not allowed) the collector will notify the claimant and demand payment of the tax. If the tax is not then paid within 10 days the 5 per cent penalty will be assessed on the amount of tax not abated. If abatement of the entire tax was not requested and the balance of the tax was not paid within the required 10 days, the 5 per cent penalty accrues immediately on such balance. Interest is to be added in all cases in which the demand of payment is made of the taxpayer personally, although he subsequently dies, or becomes insane or insolvent, so that collection of the tax is made from his estate in the hands of his legal representative; but the estate of a deceased person, regardless of the date of his death, or of an insane or insolvent person, can not be charged with liability to the 5 per cent penalty on account of his or the fiduciary's delinquency in making payment of the tax. This article applies to the assessment and collection of taxes which have accrued or may accrue under the

Revenue Act of 1918, and the Revenue Act of 1921, and except insofar as it relates to the installment plan of payment, under the Revenue Act of 1917. (Reg. 45, Arts. 1003 and 1006.)

RULING. The interest collectible under section 250 (e)[18] of the Revenue Act of 1918 upon the amount of tax due and unpaid 10 days after notice and demand by the collector should be computed only upon the amount of tax shown by the return to be due, and not upon the tax plus the five per cent penalty. (C. B. 3, page 290; O. D. 725.)

But if the taxpayer has been subjected to the 25 per cent or 50 per cent penalty, the 5 per cent penalty and interest are computed upon the amount of the tax plus the penalty.

RULINGS. In cases where an addition of 25 per cent or 50 per cent is made to the tax on account of delinquency or fraud, and the taxpayer fails to pay the tax within 10 days after notice and demand from the collector, the 5 per cent penalty, and interest attach not only to the amount of tax shown to be due by the return, but also to the 25 per cent or 50 per cent addition to the tax. (C. B. 2, page 229; O. D. 441.)

A filed an amended return showing a lesser amount of tax due than was shown in his original return, but did not file a claim for abatement of the excess tax shown in his original return until after 10 days following notice and demand from the collector for payment of the tax due, assuming that the amended return was a substitute for the original return. The claim was subsequently allowed.

The 5 per cent penalty and 1 per cent interest will not be asserted for the reason that the allowance of the claim for abatement is evidence of the fact that the tax was not originally actually due and payable by the taxpayer. (C. B. 4, page 324; O. D. 846.)

There has been submitted for a ruling the following question:

Is there a penalty of 5 per cent and a penalty of interest at the rate of 1 per cent a month, which can be assessed against a taxpayer filing a delinquent return and paying therewith all of the tax due, which penalties are to be computed, not with any reference to the first quarterly installment, but on the entire amount of tax from March 15 until paid?

Where a delinquent return is filed and the whole amount of tax is paid at the time of filing, the penalty of 5 per cent of the first installment attaches and also the interest on such installment at the

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[18] See page 144.

rate of 1 per cent per month from the due date of the return, as fixed by statute, to the time the tax was actually paid, the due date in the case of the taxpayer rendering his returns on a calendar year basis being March 15. The instructions on the return constitute notice and demand for the first installment only, and where the first installment is not paid on or before the due date, such penalty and interest provisions apply to so much of the first installment as was not paid on time. The balance of the tax over and above the amount of the first installment becomes due and payable upon notice and demand by the collector. If the whole or any part of such balance remains unpaid after 10 days from such notice and demand, the penalty and interest provisions of section 250 (e) apply to the unpaid amount.

The first installment is due at the time fixed by law for filing the return; that is, on March 15 in the case of returns made on a calendar-year basis. The law also provides that the instructions printed on the return are deemed sufficient notice and demand. Accordingly, if the first installment is not paid on March 15, it becomes delinquent, and in such cases the 5 per cent penalty and interest at the rate of 1 per cent per month, from March 16, should be collected on the first installment.

The 5 per cent penalty is assessed by law; it is asserted, compromised, or waived as the case may be, by the Department.

O. D. 313, C. B. 1, p. 249, overruled. (B. 47-21-1935; O. D. 1111.)

Penalties apply only after notice and assessment.—Penalties for failure or delay in the payment of tax are not applied until after assessment has been made and notice has been given to the taxpayer, except (1) when extensions of time are secured by taxpayers,[19] and (2) when there is negligence (without intent to defraud) on the part of the taxpayer.

Ruling. No interest is collectible on the difference between the amount of tax paid on the basis of an original return and that shown to be due by an amended return if the understatement in the original return was not due to negligence of the taxpayer. (C. B. 3, page 290; O. D. 691.)

Penalties in case of death of delinquent.—Section 250 (e) of the law specifically exempts "estates of insane, deceased or insolvent persons" from the 5 per cent penalty and interest at

[19] Sections 250 (a) and 250 (f).

the rate of 1 per cent a month otherwise imposed if the tax remains unpaid after ten days notice and demand.[20]

The exemption also applies to the 6 per cent interest added when claims for abatement are disallowed.

REGULATION. . . . . the estate of a deceased person, regardless of the date of his death, or of an insane or insolvent person, cannot be charged with a liability to the 5 per cent penalty on account of his or the fiduciary's delinquency in making payment of the tax.[21] . . . . (Art. 1003.)

Penalty paid on illegal tax may be recovered.—In *Camp Bird v. Howbert,*[22] it was held that, where an illegal tax is paid, the fact that it was not paid within the time allowed by law will not prevent any taxpayer from recovering the penalty of 1 per cent per month paid by him for the non-payment of an illegal tax. If the tax was illegal it was never due and therefore the penalty was as much unauthorized as the tax itself.

In an opinion[23] dated June 3, 1919, the United States Attorney General held that claims falling in the following classes

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[20] [Former Procedure] Under the 1918 law, exemption from penalty, however, did not extend to a decedent's estate when claim for abatement on the ground of loss in inventory had been disallowed. Section 214 (a-12), covering inventory claims, does not mention estates, etc., as in section 250 (e), this distinction apparently being the basis for the following:

REGULATION. ". . . . But if any part of a claim for abatement on the ground of a loss in inventory under section 214 (a) (12) . . . . of the statute is disallowed, interest from the original due date at the rate of 12 per cent per annum will be added to the tax not abated; and interest is to be added in all cases in which the demand of payment is made of the taxpayer personally, although he subsequently dies, or becomes insane or insolvent, so that collection of the tax is made from his estate in the hands of his representative. . . . ." [Reg. 45 (1918), Art. 1003.]

[21] [Former Procedure]

REGULATION. "Specific penalties provided by the income tax law are held to attach to the person and in case of death of such person are non-enforceable.

"*Ad valorem* penalties (those measured by income) attach to income and are to be enforced regardless of the death of the owner of the income by which the penalty is measured." (Reg. 33, 1918, Art. 52.)

[22] 262 Fed. 114. Petition for writ of certiorari denied, March 8, 1920, 252 U. S. 579; 64 L. Ed. 725; 40 S. Ct. 344.

[23] 31 Op. Att. Gen. 459.

[Former Procedure] Prior to this opinion it was held by some authorities that the Commissioner had no power to mitigate the 25 and 50 per cent penalties.

may be compromised by the Commissioner whenever, in his judgment, such compromises are for the interest of the United States:

(1) Claims for amounts 50 per cent in addition to amounts of income and excess-profit taxes assessed under authority of section 3176 of Revised Statutes, as amended by section 16 of the act of September 8, 1916, and of section 212 of the act of October 3, 1917, in cases of failure to make and file returns or lists within the time prescribed by law or by the collector;

(2) Claims for amounts 100 per cent in addition to amounts of income and excess-profit taxes assessed under authority of said sections in cases of false or fraudulent returns or lists willfully made; . . . .

Collectors have no authority to waive penalties or interest.[21]

When specific penalties will not be subject of suit.—In view of the extraordinary conditions now existing it is believed by some that many taxpayers have subjected themselves to penalties. Under the circumstances it may be of interest to reproduce instructions to collectors regarding the imposition of the specific penalties and the attempt to recover them by suit.

RULING. Liability to specific penalty attaches upon all delinquent returns and is recoverable by suit. By Section 3214 R. S. the Commissioner of Internal Revenue may or may not institute suit. It has been decided not to institute suit nor to assert specific penalty in certain cases. The assertion of specific penalty does not depend upon the fact of whether or not the 50 per cent addition to tax has been assessed. In some cases where the 50 per cent addition to tax must be assessed because the return was filed after notice from the collector, the specific penalty will not be asserted. It will not be asserted, regardless of whether the 50 per cent addition to tax has been assessed, in cases falling under any of the following designations:

1. Extension granted. Where a return is filed within the thirty-day period of extension granted by the collector or within a further period of extension granted by the Commissioner of Internal Revenue, as provided by Section 14 (c) of the act of September 8, 1916.

2. Return on time. Specific penalty will not be asserted upon an amended return provided the original return was filed within the prescribed time.

3. Mailed in time. Where an affidavit is filed satisfactorily estab-

[21] I-2-22; I. T. 1161.

lishing that the return was placed in the mails in ample time to reach the collector's office in ordinary course of mails before the close of business on the final day for filing.

4. Tentative return. Where an informal return was filed within the time prescribed. The return of a parent company including therein the income of a subsidiary company will be accepted as a tentative return of the subsidiary company, if the fact is stated that the tentative return includes the income of the subsidiary.

5. Filed in wrong district. Where the return was filed in some other collection district within the prescribed time.

6. Net income under $3,000. Where it develops that the net income of an individual for 1913, 1914, 1915 or 1916 was less than $3,000, or under the act of October 3, 1917, for 1917, etc., less than $1,000 or $2,000.

7. Erroneous information. Where the delinquency is alleged to be due to erroneous or misleading information given by officials or employees of the Internal Revenue Service and there is no evidence in conflict therewith.

8. Organization incomplete. Where it is established that the organization of a corporation, joint-stock company or association, or insurance company was not completed until after the expiration of the period for which the return should have been filed.

9. Death. Where by reason of the death of an individual his return for the year or portion of the year prior to his death is not filed within the time prescribed. The death of a delinquent abates liability to specific penalty. An administrator or executor is charged with the duty of rendering a return for the decedent, and if he is appointed in ample time to make the return prior to March 1 and fails to do so, he should be charged as delinquent and the specific penalty should be asserted against him. The administrator or executor will not be relieved from specific penalty unless the return is made within a reasonable time after his appointment.

10. Severe illness or unavoidable absence. Where it is clearly established that the delinquency in the filing of a return of an individual or of a corporation within the time prescribed was due to severe illness of the individual or of an officer of a corporation whose duty it was to prepare or sign the return, or to unavoidable absence from place of business or place of abode.

11. Absence from the United States. Where it appears that the filing of a return within the time prescribed was rendered impossible by reason of absence from the United States. Delinquency beyond the period of extension which may be granted by the Commissioner of Internal Revenue will not be excused under this heading.

12. Military or naval service of United States. Where the delinquency of an individual was occasioned by service in the military or naval forces of the United States.

13. Not organized for profit. Comprehends numerous small corporations not organized primarily for profit, such as local telephone companies, co-operative purchasing societies, etc., concerning whose liability under the law to make a return there may have been a reasonable doubt.

14. Inactive corporations. Those which transacted no business and had no income during the return year.

15. Fiscal year. Corporations which have established a fiscal year in the manner prescribed by law which file a return on or before the first day of the third month following the close of the fiscal year.

16. Assigned. Where corporations have made an assignment on account of insolvency and do not intend again to engage in business.

17. Insolvent. Where the assets of a corporation are insufficient for the payment of its debts and the corporation has ceased to do business.

18. Charter forfeited. Where, prior to the date when the return was due, the charter of a corporation is forfeited on account of noncompliance with state laws. It must be clear, however, that business in the name of the corporation was suspended at the time of such forfeiture. If business was continued under the same name, the concern will be held to be an association and the same liabilities will attach as if the charter had not been forfeited.

19. Defunct. Where corporations are out of business, have no assets, maintain no organization, and the purpose for which organized has been abandoned.

20. Dissolved. Where all the assets of a corporation have been distributed.

21. Sale. Where corporations have disposed of all their assets and property by sale to other corporations, firms, or individuals and business is no longer carried on under their charters.

22. Consolidated, merged or succeeded. Where corporations have terminated their existence as represented by these terms and it appears that no assets or property remain in the name of the retiring corporation.

23. No assets. Includes all corporations having no assets from which to submit an offer in compromise.

In cases not included in any of the above classes, the specific penalty will be asserted, and if the delinquency was not due to an intention to delay the administration of the law the minimum amount which will be accepted in compromise is as follows:

> $5 in the case of an individual or withholding agent.
> $10 in the case of a corporation, joint-stock company or association, or insurance company.

These amounts will be considered insufficient and will not be accepted in any case where it appears that a taxpayer was intention-

ally violating the provisions of law, and purposely delaying the filing of the returns. In all cases where revenue agents or other examining officers discover that any individual has an appreciable taxable income and the examining officer is of the opinion that the individual knew or should have known that he was required to make a return, he should make a recommendation as to the minimum amount which should be accepted as an offer in compromise, and where the intent to evade tax is plain he should recommend prosecution. Special attention should be called to cases of individuals having a taxable income who have failed to file returns for a number of years.

In all cases of delinquency discovered by revenue agents and other examining officers, if the delinquency falls within a period for which the penalty can be asserted, such officers should secure from the delinquent a sworn statement setting forth the reason for delinquency. This statement should be attached to the return forwarded to the collector. The examining officer should state in his report the alleged reason for delinquency and if he is of the opinion that the minimum amount should not be accepted as an offer in compromise of liability to specific penalty, he should make a recommendation as to the minimum amount which should be accepted. Consideration will be given such recommendation by this office in accepting an offer in compromise. In forwarding offers in compromise on form 656 collectors should call attention to revenue agents' reports, if any, in which the non-acceptance of the minimum amount as an offer in compromise is recommended. The statement or affidavit attached to the return setting forth the reason for delinquency is not in lieu of the affidavit required to be attached to form 656. (Mim. Letter to Collectors No. 1675, November 3, 1917.)

Suits for penalties barred after 5 years.—Section 1047, Revised Statutes, in part, is as follows:

LAW. Section 1047 [Rev. Stat.]. No suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specially provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. . . . .

Limitation on prosecution for criminal violations.—

LAW. Section 1321. (a) That the Act entitled "An Act to limit the time within which prosecutions may be instituted against persons charged with violating internal-revenue laws," approved July 5, 1884, is amended to read as follows:

"That no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information insti-

tuted within three years next after the commission of the offense: *Provided,* That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings: *Provided further,* That the provisions of this Act shall not apply to offenses committed prior to its passage: *Provided further,* That where a complaint shall be instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district: *And provided further,* That this Act shall not apply to offenses committed by officers of the United States."

(b) Any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceeding shall be subject to the limitations imposed by law prior to the passage of this Act.

LAW. Section 1046. [Rev. Stat.] No person shall be prosecuted, tried, or punished for any crime arising under the revenue laws, ... unless the indictment is found or the information is instituted within five years next after the committing of such crime.

No person shall be prosecuted, tried or punished for any of the various offenses arising under the internal revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense, in all cases where the penalty prescribed may be imprisonment in the penitentiary, and within two years in all other cases: *Provided,* That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings:

Compromise of penalty a bar to prosecution.—In a recent case[25] in which internal revenue officers, after defendant had admitted that he had not filed an income tax return as required by section 1004, accepted not only the tax but the penalty, informing defendant that such payment would end the matter and there would be no indictment, it was held that such acceptance and statement was a "compromise" within section 3229, Revised Statutes, and was a bar to prosecution.

[25] *Rau v. U. S.,* 260 Fed. 131; 171 C. C. A. 167.

CHAPTER VII

RATES AND COMPUTATION OF TAX

The changes in rates and in the computation of tax under the 1921 law may be summarized as follows:

1. There is a decrease in the individual surtax rates for 1922.
2. There is an increase in the corporation income tax rate to 12½ per cent for 1922.
3. Capital net gains are taxed at a flat rate of 12½ per cent (including normal tax), from January 1, 1922.
4. Computations in case of fiscal years of individuals, partnerships, personal service corporations, and regular corporations are changed.
5. When return is made for less than one year, income is calculated on annual basis.
6. When individuals are not entitled to increased exemption, or specific credit of $2,000 is denied a corporation, special computations are necessary.

Rates

The 1921 law introduces an additional problem for the taxpayer because of a change in rates, a change of basis of taxation (as in the case of personal service corporations after December 31, 1921), and because of the adjustments that must be made in the case of fiscal year taxpayers whenever the tax rates and basis of taxation (such as elimination of excess profits tax after 1921) are changed.

Under the 1921 law the rates of tax imposed by the 1918 law remain unchanged for 1921, but are changed commencing January 1, 1922.

Rates applicable to individuals.—The total rate applying to the income of individuals consists of two parts, the normal tax and the surtax. For the calendar year 1921 and subsequent years, the normal tax is a flat rate of 8 per cent (reduced to 4 per cent upon the first $4,000 subject to normal tax).[1] The surtaxes begin to apply when the net income exceeds $5,000 for 1921 and $6,000 for 1922 and are rapidly progressive.

The rates are applied to "net income" which is ascertained by subtracting specified deductions from "gross income," the latter being defined in the law to include the distributive shares of the profits of partnerships and personal service corporations. Beginning with January 1, 1922, personal service corporations are taxed as ordinary corporations, and the undistributed profits thereof are not taxed to the individual stockholders.[2]

The terms "gross income" and "net income" are fully explained in Chapter XIII. For the purposes of the normal tax only, further deductions are permitted under the title of "credits."[3] These credits consist of dividends, interest on certain securities, and the personal exemptions of $1,000, $2,000, or $2,500, together with $400 for each dependent.

NORMAL TAX.—

LAW. Section 210. **That, ... there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum[4] of the amount of the net income in ex-**

[1] Citizens or residents of the United States entitled to the benefits of section 262 are subject to normal tax at the rate of 4 per cent on the first $4,000 of total net income *from sources within the United States*, in excess of credits and 8 per cent on the balance. See Chapter XXXVI.

[2] Section 218 (d).

[3] See XXV.

[4] **[Former Procedure]** The normal rate under the 1913 law was 1 per cent (section II, A, sub. 1). This applied for the years 1913, 1914 and 1915. The 1916 law made the normal rate 2 per cent [section 1 (a)]. This rate was in force for one year (1916) before it was supplemented by an additional normal tax of 2 per cent (1917 law, section 1). Consequently in 1917 the normal tax amounted to 4 per cent in all, the entire 4 per cent, however, not applying to the smaller incomes. The normal

cess of the credits provided in section 216:[5] *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

SURTAX.—For 1921 all individual net incomes in excess of $5,000 are subject to surtaxes.[6] For 1922 and subsequent years the surtaxes start at $6,000.[7]

The personal exemptions and other credits such as dividends do not relieve the taxpayer of surtaxes.[8]

The surtax rates for 1921 are the same as in the 1918 law, increasing 1 per cent with each $2,000 of income, until the rate of 48 per cent is applied to the increment between $98,000 and $100,000. Thereafter the steps are more widely separated, until a maximum is reached of "65 per centum of the amount by which the net income exceeds $1,000,000."

The surtax rates for 1922, starting with 1 one per cent on the $4,000 between $6,000 and $10,000, increase by 1 or 2 per cent steps, and reach 47 per cent of income between $98,000 and $100,000. The maximum rate is 50 per cent of all over $200,000. Thus on incomes up to $100,000 the surtax is slightly less and on incomes over $100,000 the rates are considerably reduced, as compared with 1921.

The House bill provided for same surtax rates as under 1918 law to $66,000 with a flat rate of 32 per cent on all over that amount. As passed by the Senate the bill provided for a maximum rate of 50 per cent on all over $200,000.

The rates which apply to each successive increment of income, the tax which results from the application of the rates

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rate for the calendar year 1918 was 12 per cent upon net incomes exceeding $4,000 and 6 per cent on the first $4,000 or any part thereof. In the case of the individual's fiscal year, beginning in 1918, the rates of 1918 were applicable to a portion of the year's income. See *Income Tax Procedure*, 1920, page 111.

[5] See Chapter XII.

[6] Section 211 (a-1).

[7] Section 211 (a-2).

[8] See Chapter XII.

to the increments, and the cumulation of these taxes, are set forth in the following table:[9]

In 1916 the surtax rates were changed to the scale shown in column A in the table given below [1916 law, section 1 (b)]. These rates applied in 1916, and in 1917 the scale of rates shown in column B was added to the 1916 rates and the resulting combined rates shown in column C were imposed for that year.

Net income subject to tax	A 1916 law (percentage)	B 1917 law (percentage)	C Total surtax applied in 1917 (percentage)
$ 5,000 to $ 7,500	..	1%	1%
7,500 " 10,000	..	2	2
10,000 " 12,500	..	3	3
12,500 " 15,000	..	4	4
15,000 " 20,000	..	5	5
20,000 " 40,000	1%	7	8
40,000 " 60,000	2	10	12
60,000 " 80,000	3	14	17
80,000 " 100,000	4	18	22
100,000 " 150,000	5	22	27
150,000 " 200,000	6	25	31
200,000 " 250,000	7	30	37
250,000 " 300,000	8	34	42
300,000 " 500,000	9	37	46
500,000 " 750,000	10	40	50
750,000 " 1,000,000	10	45	55
1,000,000 " 1,500,000	11	50	61
1,500,000 " 2,000,000	12	50	62
On excess of 2,000,000	13	50	63

In 1918, 1919, and 1920 the surtax rates were the same as those given on page 158 for 1921.

[9] [Former Procedure] Under the 1913 law (section II, A, sub. 2) the surtax rates on net income of individuals were as follows:

Net income subject to tax	$ 20,000 to $ 50,000	1%
" " " "	50,000 " 75,000	2
" " " "	75,000 " 100,000	3
" " " "	100,000 " 250,000	4
" " " "	250,000 " 500,000	5
" " " "	500,000 and over	6

These rates were in force in 1913, 1914 and 1915.

SURTAX RATES AND AMOUNTS OF SURTAXES PAYABLE UNDER 1921 LAW

Net Income	1921			1922 and subsequent years		
	Per cent	Surtax	Total cumulative surtax*	Per cent	Surtax	Total cumulative surtax*
$ 5,000 to $ 6,000	1%	$10	$10	......	....	....
6,000 " 8,000	2	40	50	1%	20	20
8,000 " 10,000	3	60	110	1	20	40
10,000 " 12,000	4	80	190	2	40	80
12,000 " 14,000	5	100	290	3	60	140
14,000 " 16,000	6	120	410	4	80	220
16,000 " 18,000	7	140	550	5	100	320
18,000 " 20,000	8	160	710	6	120	440
20,000 " 22,000	9	180	890	8	160	600
22,000 " 24,000	10	200	1,090	9	180	780
24,000 " 26,000	11	220	1,310	10	200	980
26,000 " 28,000	12	240	1,550	11	220	1,200
28,000 " 30,000	13	260	1,810	12	240	1,440
30,000 " 32,000	14	280	2,090	13	260	1,700
32,000 " 34,000	15	300	2,390	15	300	2,000
34,000 " 36,000	16	320	2,710	15	300	2,300
36,000 " 38,000	17	340	3,050	16	320	2,620
38,000 " 40,000	18	360	3,410	17	340	2,960
40,000 " 42,000	19	380	3,790	18	360	3,320
42,000 " 44,000	20	400	4,190	19	380	3,700
44,000 " 46,000	21	420	4,610	20	400	4,100
46,000 " 48,000	22	440	5,050	21	420	4,520
48,000 " 50,000	23	460	5,510	22	440	4,960
50,000 " 52,000	24	480	5,990	23	460	5,420
52,000 " 54,000	25	500	6,490	24	480	5,900
54,000 " 56,000	26	520	7,010	25	500	6,400
56,000 " 58,000	27	540	7,550	26	520	6,920
58,000 " 60,000	28	560	8,110	27	540	7,460
60,000 " 62,000	29	580	8,690	28	560	8,020
62,000 " 64,000	30	600	9,290	29	580	8,600
64,000 " 66,000	31	620	9,910	30	600	9,200
66,000 " 68,000	32	640	10,550	31	620	9,820
68,000 " 70,000	33	660	11,210	32	640	10,460
70,000 " 72,000	34	680	11,890	33	660	11,120
72,000 " 74,000	35	700	12,590	34	680	11,800
74,000 " 76,000	36	720	13,310	35	700	12,500
76,000 " 78,000	37	740	14,050	36	720	13,220
78,000 " 80,000	38	760	14,810	37	740	13,960
80,000 " 82,000	39	780	15,590	38	760	14,720
82,000 " 84,000	40	800	16,390	39	780	15,500
84,000 " 86,000	41	820	17,210	40	800	16,300
86,000 " 88,000	42	840	18,050	41	820	17,120
88,000 " 90,000	43	860	18,910	42	840	17,960
90,000 " 92,000	44	880	19,790	43	860	18,820
92,000 " 94,000	45	900	20,690	44	880	19,700
94,000 " 96,000	46	920	21,610	45	900	20,600
96,000 " 98,000	47	940	22,550	46	920	21,520
98,000 " 100,000	48	960	23,510	47	940	22,460
100,000 " 150,000	52	26,000	49,510	48	24,000	46,460
150,000 " 200,000	56	28,000	77,510	49	24,500	70,960
200,000 " 300,000	60	60,000	137,510	50	50,000	120,960
300,000 " 500,000	63	126,000	263,510	50	100,000	220,960
500,000 " 1,000,000	64	320,000	583,510	50	250,000	470,960
1,000,000 up	65	....	....	50	....	....

*To ascertain the total tax payable, the normal tax of 8 per cent (reduced to 4 per cent on the first $4,000) must be applied to the total net income minus the credits, and the result added to the figures given in this table.

The official directions for interpreting the foregoing table read as follows:

REGULATION. . . . . The surtax for any amount of net income not shown in the above tables is computed by adding to the total surtax for the largest amount shown, which is less than the income, the surtax upon the excess over that amount at the rate indicated in the table. For example, if the amount of net income is $63,128, the surtax for calendar year 1921 is the sum of $8,690 (the surtax upon $62,000 as shown by Table I) plus 30 per cent of $1,128, or $338.40, making a total surtax of $9,028.40. . . . . (Art. 12.)

The total surtax of $9,028.40 shown in the foregoing is based on 1921 rates. At 1922 rates the surtax would be $8,347.12 (the surtax as shown by the table, $8,020, plus 29 per cent of $1,128, or $327.12, making a total surtax of $8,347.12).

Surtax on sale of mineral deposits.—

LAW. Section 211. . . . . **(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, for the calendar year 1921, 20 per centum, and for each calendar year thereafter 16 per centum, of the selling price of such property or interest.**

The new law re-enacts the provision of the 1918 law limiting the surtax to 20 per cent of the selling price, for 1921, in case of the sale of mineral properties, but for 1922 and subsequent years the limit is placed at 16 per cent.

REGULATION. Where the taxpayer by prospecting and locating claims, or by exploring and discovering undeveloped claims, has demonstrated the principal value of mines, oil or gas wells, which prior to his efforts had a relatively minor value, the portion of the surtax attributable to a sale of such property or of the taxpayer's interest therein shall not exceed for the calendar year 1921, 20 per cent, and for subsequent calendar years 16 per cent of the selling price. Exploration work alone without discovery is not sufficient to bring a case within this provision. Shares of stock in a corporation owning mines, oil or gas wells, do not constitute an interest in such property. To determine the application of this provision to a particu-

lar case the taxpayer should first compute the surtax in the ordinary way upon his net income, including his net income from any such sale. The proportion of the surtax indicated by the ratio which the taxpayer's net income from the sale of the property, or his interest therein computed as prescribed in article 715,[10] bears to his total net income is the portion of the surtax attributable to such sale, and if it exceeds for the calendar year 1921, 20 per cent and for subsequent calendar years 16 per cent of the selling price of the property or interest, such portion of the surtax shall be reduced to that amount.[11] (Art. 13.)

If the taxpayer has held the property for more than two years, he may, however, elect to be taxed at a maximum rate of 12½ per cent under the capital gains provision.[12]

RULING. Where individuals transfer property to a corporation which later demonstrates the principal value of such property as oil-producing property "by prospecting or exploration and discovery work" and then dissolves, transferring the property to the individuals, who remain stockholders without change in interests, and such stockholders sell the property, the portion of the surtax attributable to such sale is not limited to 20 per cent of the selling price of such property or interests under the provisions of section 211 (b). (C. B. 1, page 57; T. B. R. 8.)

It is well to bear in mind that in computing the profit on the sale of oil wells the "discovery value" is not a factor. The "discovery" itself operates to give the seller the benefit of the 20 per cent tax. The "discovery value" is used only in computing the depletion allowance. Some confusion has arisen on this point in rulings handed down by the Committee on Appeals and Review and by the Advisory Tax Board, but the question was definitely settled in Solicitor's Opinion 26, C. B. 4, page 44.

Rates applicable to corporations.—The new law imposes on corporations, for 1921, the same rate of income tax, viz., 10 per cent, as was imposed for 1919 and 1920 under the 1918 law, and the same rates of excess profits tax. For 1922

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[10] See Appendix A, Chapter V.
[11] *Ibid.*
[12] Section 206, see Chapter XVII.

and subsequent years the income tax rate is 12½ per cent. The excess profits tax is not imposed on net income which accrues after January 1, 1922.[13]

CORPORATIONS IN GENERAL.—

LAW. Section 230. **That, ... there shall be levied, collected, and paid for each taxable year upon the net income of every corporaion a tax at the following rates:**

(a) For the calendar year 1921,[14] 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.[15]

Although the limitation of tax on capital gains does not apply to corporations, no hardship is suffered by a corporation because the minimum tax under those provisions[16] in any event must amount to 12½ per cent, which is the rate imposed upon corporations.

Computation of the Tax

The application of the rates, the arrangement upon the return blanks of the various items going to make up the tax base, the subtraction of the various credits and deductions, and the calculation of the tax payable are problems which have been greatly complicated by the extension of the privilege of reporting upon the basis of fiscal years to individuals taxable at progressive rates.[17]

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[13] See Appendix A.

[14] **[Former Procedure]** The 1913 rate on corporate incomes was identical with the normal rate on individual incomes, 1 per cent [section II, G (a)]. Again in the 1916 law it was made the same, 2 per cent (section 10). In 1917, however, when an additional normal tax of 2 per cent was made to apply to individuals, the additional corporation rate was made 4 per cent (section 4), the total rate applying to corporations in 1917 being 6 per cent as compared with a total normal tax of 4 per cent on individuals. Corporations were permitted to take credit, in the case of dividends received, for only 4 per cent in place of 6 per cent, the 2 per cent difference operating as a penalty upon the corporate form. The rate for 1918 was fixed at 12 per cent, and for 1919 and 1920 at 10 per cent.

For rates on transportation companies under government control, see *Income Tax Procedure,* 1921, page 154.

[15] See page 166.

[16] See Chapter XVII.

[17] See page 164.

The 1921 law specifies the procedure to be followed in certain cases which the regulations issued by the Treasury have greatly amplified.

Reconcilement of returns and books of account.—In various parts of this book the author has called attention to the desirability of maintaining uniformity between the tax returns and the books of account. When tax rates were low it made little difference to the taxpayer whether or not the returns could readily be reconciled with his books. Preparation of the returns with the numerous adjustments required has been such an annoying matter and the time allowed for preparing returns has been so limited, that the matter was dismissed with a sigh of relief as soon as the returns were filed. The honest taxpayer is quite as likely to make mistakes against himself as against the government.

With high rates in effect it is most important that returns be accurate, in the interest of both taxpayers and government. It is impossible to know that a return is accurate unless it is reconciled with the books of account. It must be known that every item omitted from or added to the books and every item omitted from or added to the returns is justified, and in subsequent periods it must be readily apparent why the omissions and additions occurred.

In addition to a hasty examination which is made soon after filing, the Treasury's policy is to examine in a detailed and exhaustive manner every return which involves or should involve a substantial amount of tax. Taxpayers will avoid many hours of annoyance if a careful memorandum is kept of all differences between books and returns. A complete form for recording the reconciliation between books of account and income and excess profits tax returns is given in *Excess Profits Tax Procedure,* 1921.

Capital net gains taxed at 12½ per cent.—A new provision is found in the 1921 law,[18] under which gains from the sale

[18] Section 206.

or exchange of capital assets are taxed at 12½ per cent instead of at the higher rates when the tax on net income is computed at the regular normal and surtax rates. For a full discussion of capital gains, capital deductions, and for illustrations of the necessary computations, see Chapter XVII.

Fiscal years ending in 1921.—

LAW. Section 205. **(a) That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period.**

Any amount paid before or after the passage of this Act on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1918 shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, the excess shall be credited or refunded in accordance with the provisions of section 252.[19]. . . .

REGULATION. In computing the tax attributable to the calendar year 1920 the net income computed for the entire period under Title II of the Revenue Act of 1918 shall be credited with the amount of the excess-profits tax computed for the entire period under Title III of the Revenue Act of 1918. In computing the tax attributable to the calendar year 1921 the net income computed for the entire period under the present statute shall be credited with the amount of the excess-profits tax computed for the entire period under Title III of this statute. . . . . Amounts previously paid by the taxpayer on account of the income tax for such fiscal year shall be credited toward the payment of the income tax imposed for such fiscal year by the present statute. Any excess shall be credited or refunded in accordance with the provisions of section 252. . . . . (Art. 1623.)

The tax is computed as follows:

(a) At 1920 rates, on the entire net income as if such entire net income were earned during the calendar year 1920, and as if the 1918 law were still in force.

[19] See Chapter IX.

(b) At 1921 rates, on the entire net income as if earned during the calendar year 1921 (under the 1921 law).

(c) Add as many twelfths of the tax under (a) as there are months in 1920, to as many twelfths of the tax under (b) as there are months in 1921.

Fiscal years of individuals ended in 1921.—Assume an individual taxpayer with fiscal year ended September 30, 1921, married, with three dependents, and having net income of \$20,000. At 1920 rates (under the 1918 law) his total tax on \$20,000 is \$1,942. At 1921 rates (under 1921 law) his total tax is \$1,894. The difference of \$48 is accounted for by the fact that under the 1921 law the exemption for dependents is \$400 each instead of \$200 each. The total tax is:

3/12 of \$1,942	\$485.50
9/12 of 1,894	1,420.50
Total	\$1,906.00

Fiscal years of partnerships and personal service corporations.—Partners are taxable on their distributive shares of net income of the partnership for the taxable year of the partnership ending in the period for which the individual partner reports. Personal service corporations are taxed as ordinary corporations after December 31, 1921. In both of these cases special problems arise which are treated in Chapter XXIV, "Income from Partnerships and Personal Service Corporations."

Fiscal years of corporations ended in 1921.—The income tax rates upon corporations for 1920 and 1921 are the same, viz., 10 per cent. The net income on which the tax is based may differ as computed for 1920 (under the 1918 law) and for 1921 (under the 1921 law) in such items as bad debts, interest paid to carry Liberty bonds, etc. All corporations which have a fiscal year ended in 1921 should prepare new returns under the 1921 law, even though the tax rate is unchanged.

Fiscal years ending in 1922.—

LAW. Section 205. . . . . (b) **If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title (as in force on December 31, 1921) at the rates for the calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title (as in force on January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922 is of the entire period:** *Provided,* **That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2).**[20]. . . .

The principle of prorating the tax as indicated above in the case of 1920-1921 fiscal years, is also applied to 1921-1922 fiscal years. The important change in the case of individuals is the decrease in the surtax rates in 1922. The repeal of the excess profits tax in the case of corporations, as of December 31, 1921, gives rise to a special problem in the fiscal years 1921-1922.

Fiscal years of corporations ending in 1922.—In the case of fiscal years ending in 1922, there is, of course, no excess profits tax applicable to income earned in 1922. The law [section 236 (c-2)] provides that the excess profits tax applicable to 1921 [computed under section 335 (b)] shall be credited against the net income computed for the *whole* period, in computing the income tax under section 205 (b).

If section 236 of the law is interpreted literally, the excess profits tax computed under section 335 (b) would be prorated before being applied as a credit against net income for the purpose of determining the amount subject to income tax. The following regulation permits the full excess profits tax to be credited when computing income tax under 1921 law.

REGULATION. In computing the tax for a fiscal year beginning in 1921 and ending in 1922 the procedure is as follows: (*a*) The tax attributable to the calendar year 1921 is found by computing the income of the taxpayer and the tax thereon in accordance with the

[20] See Chapter XXIV.

statute as in force on December 31, 1921, as if the fiscal year was the calendar year 1921 and determining the proportion of such tax which the portion of such period within the calendar year 1921 is of the entire period; before calculating the tax the net income computed for the entire period shall be credited with the excess-profits tax computed for the entire period under Title III of this statute as if the fiscal year was the calendar year 1921; (*b*) the tax attributable to the calendar year 1922 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as in force on January 1, 1922, as if the fiscal year was the calendar year 1922, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year 1922 is of the entire period; and (*c*) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1921 to the tax attributable to the calendar year 1922. . . . . (Art. 1624.)

The following illustration shows how the income tax is computed under the foregoing regulation:

COMPUTATION OF INCOME TAX—FISCAL YEAR ENDING MAY 31, 1922

Net income for full year (before taxes)	$240,000	
Excess profits tax for full year	36,000	
	$204,000	
Income tax at 10%		$20,400
Excess profits tax as above		36,000
Total tax		$56,400
Tax for 7 months in 1921 (7/12 of $56,400)		$32,900
Net income	$240,000	
Income tax at 12½%	$ 30,000	
Tax for 5 months in 1922 (5/12 of $30,000)		12,500
Total tax payable		$45,400
Consisting of excess profits tax (7/12 of $36,000)	$ 21,000	
Income tax (7/12 of $20,400 plus 5/12 of $30,000)	24,400	
	$45,400	

The computation set forth above, authorized by the regulations, prevents prorating twice the excess profits credit.[21]

[21] For illustration of the imposition of excessive income tax due to method of prorating excess profits tax, for fiscal years ended in 1917, see *Income Tax Procedure*, 1919, pages 125-128; for fiscal years ended in 1919, see *Income Tax Procedure*, 1920, pages 145-149.

Return for period of less than one year—placing income on annual basis.—A new provision has been inserted in the 1921 law whereby in the case of returns for less than one year the tax is to be computed after the income has been placed on an annual basis:

LAW. Section 226. . . . . (c) **In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.**

This change has a material effect on the tax payable by individuals who are subject to the graduated surtaxes[22] but should have no effect on the tax payable by a corporation.

CORPORATIONS.—Whether the tax is computed on the basis of the actual income for the period, the various credits being proportionately reduced (the practice under the 1918 law), or whether the income is placed on an annual basis and the tax computed, *full credits being allowed*, and the resulting tax being prorated, should make no difference. This is shown by the following examples:

METHOD A—NOT REDUCING EXEMPTIONS AND CREDITS

Net income (6 months)		$ 12,000
Net income placed on an annual basis ($\frac{12}{6} \times$ \$12,000) [Section 226 (c)]		24,000
Invested capital		150,000
Excess profits credit:		
8% of invested capital ($150,000)	$12,000	
Specific	3,000	
Total	15,000	
Net income (all in 20% bracket)	24,000	
Less: Excess profits credit	15,000	
Subject to excess profits tax	9,000 at 20%	
Excess profits tax		1,800

[22] See page 169.

Net income		$24,000		
Less: Excess profits tax	$1,800			
Specific	2,000	3,800		
Subject to income tax		20,200	at 10%	
Income tax				$ 2,020
Total				3,820
Tax for 6 months (½ of $3,820)				1,910

Method B—Reducing Exemptions and Credits

Net income (6 months)				12,000
Invested capital				150,000
Excess profits credit:				
8% of invested capital ($150,000)		$12,000		
Specific		3,000		
Total		15,000		
½ of $15,000		7,500		
Net income (all in 20% bracket)		12,000		
Less: Excess profits credit		7,500		
Subject to excess profits tax		4,500	at 20%	
Excess profits tax				$ 900
Net income		12,000		
Less: Excess profits tax	$ 900			
Specific (½ of $2,000)	1,000	1,900		
Subject to income tax		10,100	at 10%	
Income tax				1,010
Total tax				1,910

However, article 626 provides:

This prorated credit shall be applied to the net income before such net income is placed on an annual basis, as provided in Section 226 (c).

This regulation should be interpreted to apply only to the computation of normal tax, otherwise an application of the prorated $2,000 credit to the income before computing the excess profits tax would result in a reduction of the latter tax in a way obviously not intended by the law.

Section 236 provides "That for the purpose only of the tax imposed by section 230" (the 10 per cent corporation income tax), there shall be allowed as credits:

A specific credit of $2,000 [subdivision (b)].

"The amount of any war-profits and excess-profits taxes imposed . . . . for the same taxable year" [subdivision (c)].

The amount of excess profits tax payable in the foregoing illustration is	$ 900
The prorated credit mentioned in article 626 above (½ of $2,000) is	1,000
Total	$ 1,900
Deducting $1,900 from the net income, $12,000, leaves subject to income tax	$10,100
Placing this amount on an annual basis ($\frac{12}{6} \times$ $10,100) =	$20,200
Income tax 10% of $20,200	$ 2,020
Income tax for 6 months (½ of $2,020)	$ 1,010
Add excess profits tax for 6 months	900
Total tax for 6 months period	$ 1,910

This method of computation seems rather superfluous but it is apparently the only way in which the Treasury could reconcile sections 226 (c) and 239 (b) of the law—the latter section being retained in the 1921 law obviously by an oversight.

INDIVIDUALS.—When an individual return is made for a period less than one year and the income is placed on an annual basis, the personal exemption and the credit for dependents are not reduced. An individual reporting for, say, six months ended December 31, 1921, with net income for that period of $20,000, would compute his tax as follows:[23]

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[23] **[Former Procedure]** Section 226 of the 1918 law provided for reduction of the personal exemption and credit for dependents.

1918 LAW. Section 226. " . . . . the credits provided in subdivisions (c) and (d) of section 216, shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months."

	Income	Tax
Net income for six months	$20,000	
Placed on annual basis (20,000 x 12/6)	$40,000	
Less: Exemption (married, 3 children)	3,200	
	$36,800	
Taxable at 4 per cent	4,000	$ 160
Taxable at 8 per cent	$32,800	2,624
Surtax on $40,000 (1921 rates)		3,410
Total		$6,194
Tax payable, 6/12 of $6,194		$3,097

RULING. Where, under the Revenue Act of 1918, a taxpayer has been permitted to change his accounting period from a calendar to fiscal year basis and renders a return for the period from January 1 to the end of such fiscal year both the normal tax and the surtax shall be computed as though the return were filed for a full twelve-month period, after the reduction of the exemptions and credits provided in section 216 (c) and (d) of the Act. (C. B. 3, page 230; O. D. 723.)

Under the method prescribed by the 1918 law the tax, using the illustration above, would be computed as follows:

	Income	Tax
Net income for six months	$20,000	
Less: Personal exemption (reduced one-half)	1,600	
	$18,400	
Taxable at 4 per cent	4,000	$ 160
Taxable at 8 per cent	$14,400	1,152
Surtax on $20,000		710
Total tax		$2,022

The effect of the new method of computation is to subject the income for part of a year to the higher surtax rates which would be applied if reporting for a full year and net income were received at the same rate, using the above illustration, for twelve months as for six months. Merely because an individual receives a certain income in a six months' period, or any other period less than a year, is no reason for assuming

that he will receive a proportionate part throughout the entire twelve months. He may never receive another dollar. He may lose all he gained, say, in the first six months and more. To subject his income received for part of a year to the higher surtax rates applicable to a theoretical income which may never materialize, is inequitable.

The larger the income for the period less than a year, the greater the relative difference in tax as compared with the old method, because of the increasing rates in the higher surtax brackets.

The following illustration, given in Regulations 62, article 431, is here compared on the basis of the 1921 and 1918 laws:

For the calendar year 1921 the income tax of a married person entitled to a personal exemption of $2,000, making a return for a six months' period of $10,000 net income, is $995, computed as follows:

Net income	$ 10,000
Multiplied by 12	120,000
Divided by 6	20,000
Subtracting exemption of $2,000	18,000
Normal tax on $18,000	1,280
Surtax on $20,000	710
Total	1,990
Divided by 2	995

COMPUTATION UNDER 1918 LAW

Net income	$10,000	
Less: Exemption	1,000	
	$ 9,000	
Normal tax on $9,000		$ 560
Surtax on $10,000		110
Total		$ 670
Increased tax		$ 325

Reduction of personal exemption of individuals.—When the aggregate net income of husband and wife is in excess of $5,000, the personal exemption is reduced to $2,000. But the law provides:

LAW. Section 216. . . . . (c) **In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the**

tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000; . . . .

An illustration of the two computations necessary to determine the tax payable under the above limitation is given in Chapter XII. The point is that when the net income is slightly in excess of $5,000 (up to $5,020), the taxpayer does not have to pay more tax, because of the reduction in the exemption, than the amount of net income in excess of $5,000.

When the specific credit of $2,000 is not allowed a corporation.—If the net income of a corporation is $25,000 or less, a specific credit of $2,000 is allowed. But

LAW. Section 236. . . . . (b) . . . . if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and . . . .

The necessary computation is shown in Chapter XII.

Fractional part of a cent not to be disregarded in computation of tax.—

REGULATION. In the payment of taxes a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to one cent. Fractional parts of a cent should not be disregarded in the computation of taxes. (Reg. 45, Art. 1721.)

CHAPTER VIII

ADMINISTRATION, ASSESSMENT AND PAYMENT

Administration in General

The administration of the Revenue Act is placed in the hands of the Commissioner of Internal Revenue, referred to hereafter as the "Commissioner," subject to the general supervision and control of the Secretary of the Treasury.

Bureau of Internal Revenue.—The Bureau of Internal Revenue, referred to in this book as the "Bureau," as its name implies, is charged with the collection of all federal revenue from inland sources. There are five deputy commissioners[1] and one assistant to the Commissioner, who is authorized to act in the Commissioner's place. Income and excess profits taxes are collected through the local collectors of internal revenue, who are also charged with the collection of all other internal revenue taxes. The collectors of internal revenue are the officers who come into the most direct touch with the taxpayers and they are held primarily responsible for the proper collection of the tax in their districts. At present there are some sixty-four collection districts, each with a collector at its head assisted by a staff of subordinates. In addition there are thirty-five internal revenue divisions with internal revenue agents or supervising internal revenue agents in charge.

LAW. Section 1311. [Section 3172, Rev. Stat.] **Every collector shall, from time to time, cause his deputies to proceed through every**

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[1] The deputies are in charge of the following:
1. Income Tax Unit
2. Estate Tax Division
3. Sales Tax Unit
4. Accounts Divisions
5. Miscellaneous (publications, administration, etc.)

part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

LAW. Section 1311. [Section 3165, Rev. Stat.] **Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.**

They may summon any person residing or found within the state or territory in which their districts lie, and even in other districts, and make examinations authorized by the law. If a return is not filed, the collectors are required to make returns from their own knowledge and from such information as they can obtain through testimony or otherwise.

Procedure of the Bureau of Internal Revenue.—The steps in procedure of the Bureau of Internal Revenue have been described as follows:[2]

1. The taxpayer makes a return and pays to the collector who receives the return, one-fourth or all the tax shown due on the face of the return.

2. The collector lists the returns, shows the taxes due, makes a few obvious corrections in some cases and forwards the returns to Washington.

3. In Washington the returns are first checked against the collector's lists and the original tax is verified.

4. The "audit" of the returns begins and additional amounts of taxes due are determined; the taxpayer is informally notified and the return is sent to a separate section of the Bureau for entry on a supplemental list.

5. Supplemental lists are transmitted monthly to the collectors; the taxpayer is formally notified and the tax is due for payment within 10 days after such notice.

[2] A. E. James, *Bulletin of National Tax Association*, November, 1920.

Committee on Appeals and Review.—Under the 1918 law[3] the Commissioner was empowered to appoint an Advisory Tax Board.[4] The Board was appointed March 14, 1919, and abolished October 1, 1919.

It is said that history cannot be written at or near the time events transpire. It is too soon to write the history of the Advisory Board of 1919, but the author is willing to predict now that when the history is written it will be found that the Board performed a hard and thankless task in an energetic and equitable manner, that it decided almost insoluble problems and retained the respect and earned the gratitude of taxpayers even though it did not always give them what they wanted.

If we are ever able to evolve an organization which will enlist the active assistance of a considerable number of the best business and professional men of the country it probably will be necessary to make an arrangement whereby they will give their services for only a small part of each year. The sacrifice involved in accepting a full-time appointment is too great. The British Board of Referees decides many different problems for the British Treasury without calling upon its members for more than two weeks of service per year.

In the place of the Board, a Committee on Appeals and Review was established, the membership of which has been recruited from within the Bureau.

ORGANIZATION.—The Committee[5] is entirely independent

[3] Section 1301 (d-1).

[4] For a full discussion of its powers and procedure see *Income Tax Procedure*, 1920, pages 159-161.

[5] At the present time, the Committee is composed of the following:

N. T. Johnson, Chairman
G. R. Davis, Vice-Chairman
Leslie Gillis
C. P. Hoffman
W. H. Lawder
C. P. McGinley
R. J. Service
M. E. Stickley
F. G. Smith, Secretary

There are still two vacancies to be filled.

of the Income Tax Unit and is responsible only to the Commissioner. Its personnel embraces a chairman, vice-chairman, eight members, and a secretary, who give their entire time and attention to all matters referred to the Committee for consideration. All of the members have held responsible positions in the Bureau as heads of divisions or chiefs of sections and are either attorneys at law or accountants.

PROCEDURE.—The principal duties of the Committee are as follows:

1. Hearing and consideration of cases which have been appealed by taxpayers from the action of the Income Tax Unit.
2. Consideration of questions submitted by the Income Tax Unit upon which the advice of the Committee is asked.
3. Criticism or approval of letters making new rulings or new applications of old rulings which are submitted by the Income Tax Unit or the office of the Commissioner.
4. Criticism or approval of proposed Treasury decisions.
5. Consideration of matters presented in informal conferences by officers of the Bureau and by taxpayers upon questions of interpretation, policy, or procedure.

Cases may be appealed to the Committee only after final disposition has been made of the case by the Income Tax Unit, and upon such questions, either as to the law or the facts, as are in controversy between the taxpayer and the Income Tax Unit.[6] The taxpayer accordingly has no cause to appeal until a decision has been rendered by the Income Tax Unit which, in the opinion of the taxpayer, is not in accordance with the law and the facts.

[6] Prior to the 1921 law, it was contrary to the policy of the Bureau to defer assessments pending the taking up of an appeal. This was an unjust rule which is now, in most cases, abolished by section 250 (d) of the 1921 law. See page 202.

The following ruling indicates the procedure which should be followed when making an appeal to the Committee:

RULING. The appeal must be filed in the office of the Commissioner in Washington within thirty-one days from the mailing of the notice,[7] but if it is mailed in time to be received by the Commissioner within such period in the ordinary course of the mails it will be considered as having been filed within such period. No particular form of appeal is required, but said appeal must set forth specifically the exceptions upon which said appeal is taken. The appeal shall be under oath and must contain a statement that it is not taken for the purpose of delay. Opportunity for a hearing shall be granted if requested within a reasonable time. The taxpayer in his appeal may rely upon the data previously submitted or he may obtain a reasonable extension of time if cause therefor is shown in which to file additional data, evidence or argument. Such request shall be under oath and must state specifically the reasons for additional time. (T. D. 3269, dated January 5, 1922.)

The following ruling outlines the procedure in hearings before the Committee:

RULING. When an appeal is taken from a ruling of the Income Tax Unit to the Committee on Appeals and Review or a question is certified to that Committee at the request of the taxpayer and an oral presentation is desired, the record shall immediately be examined to ascertain as to whether there is a question of law involved. If it is found that a question of law is involved, the Solicitor shall be notified and he will thereupon designate one member of the Solicitor's office to sit with the Committee and himself for the purpose of hearing the appeal, or if the Solicitor finds it inconvenient to sit with the Committee he may designate two members of his office to do so.[8]

At the hearing before the Committee the taxpayer or his attorney or representative will be expected to make his full oral argument on the law as well as the facts, and this presentation shall be the only oral presentation except in unusual circumstances, or unless a further argument of the facts or the law is deemed desirable by either the Chairman of the Committee or the Solicitor.

The attorney or attorneys so designated by the Solicitor for the hearing will be expected, in conjunction with the Solicitor and the Conference Committee in the Solicitor's office, if the Solicitor so desires, to consider the legal aspects of the case, and the Solicitor's recommendation in the form of an opinion or memorandum will then

[7] Notice to the taxpayer of the decision of the Income Tax Unit from which the taxpayer wished to appeal to the Committee.

[8] As a general rule, the auditor who has handled the case attends the conferences of the Committee.

be made to the Chairman of the Committee, and thereupon the Committee's findings shall be prepared and submitted to the Commissioner for his approval. . . . . (C. B. 4, page 370; O. D. 709.)

Three copies of a sworn statement of fact or brief are required.

Upon receipt of written request appealing from the action of the Income Tax Unit, together with sworn statement of facts or brief, the Income Tax Unit is requested by the Committee to submit the case and related papers to it and, upon receipt of case, the appeal is docketed for assignment to a member for consideration.

Upon assignment of case the papers are carefully examined and in the event that additional information is desired or an oral hearing has been requested or is deemed advisable, the taxpayer is notified.

In the event of an oral hearing, which is expected to be final, the taxpayer is expected to submit such arguments and presentation both as to the law and the facts as he desires to have considered by the Bureau. The oral hearing may be supplemented by a written brief to be submitted after the hearing. Three copies of this brief should be furnished.

The conclusions of the individual members of the Committee, after being formulated and reduced to writing, are submitted to a conference of the entire Committee and, when agreed to, are submitted to the Commissioner in the form of recommendations.

Upon the approval of the recommendation of the Committee by the Commissioner of Internal Revenue, the decision is final as far as the Bureau is concerned, and the decision will not be reconsidered except upon the presentation of new and material evidence, accompanied by an explanation satisfactory to the Committee of the failure to produce such evidence prior to the closing of the case.

The taxpayer is notified by the Committee of its recommendation and the case and related papers are thereupon returned to the Income Tax Unit for such further action as

may be necessary in accordance with the decision of the Committee of which action the taxpayer is duly notified by the Income Tax Unit.

Tax Simplification Board.—The new law creates what is known as the Tax Simplification Board.[9]

LAW. Section 1327. (a) That there is hereby established in the Department of the Treasury a board to be known as the "Tax Simplification Board" (hereinafter in this section called the "Board"), to be composed as follows:

(1) Three members who shall represent the public, to be appointed by the President; and

(2) Three members who shall represent the Bureau of Internal Revenue and shall be officers or employees of the United States serving in such Bureau, to be appointed by the Secretary.

(b) Any vacancy in the Board shall be filled in the same manner as the original appointment. The members representing the public shall serve without compensation except reimbursement for traveling, subsistence, and other necessary expenses incurred in the performance of the duties vested in them by this section. The members representing the Bureau of Internal Revenue shall serve without compensation in addition to that received for their service in such Bureau.

(c) The Secretary shall furnish the Board with such clerical assistance, quarters and stationery, furniture, office equipment, and other supplies as may be necessary for the performance of the duties vested in them by this section.

(d) It shall be the duty of the Board to investigate the procedure of and the forms used by the Bureau in the administration of the internal revenue laws, and to make recommendations in respect to the simplification thereof. The Board shall make a report to the Congress on or before the first Monday of December in each year.

(e) The expenditures of the Board shall be paid upon vouchers approved by the Board and signed by the chairman thereof. For the

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[9] The membership of the Board is as follows:

Appointed by the President to represent the public:

Mr. James H. Beal, of Reed, Smith, Shaw & Beal, Pittsburgh, Pa.,
Mr. Joseph E. Sterrett, of Price, Waterhouse & Co., New York, and
Mr. William T. Abbott, Vice-President, Central Trust Company of Chicago, Illinois.

Appointed by the Secretary of the Treasury to represent the Bureau of Internal Revenue:

Mr. Charles P. Smith, Assistant Commissioner of Internal Revenue,
Mr. Jesse D. Burks, Special Assistant to Deputy Commissioner of Internal Revenue, and
Mr. George W. Skilton, Assistant to Supervisor of Collectors' Offices.

expenditures of the Board for the fiscal year ending June 30, 1922, there is authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the sum of $10,000.

(f) The Board shall cease to exist on December 31, 1924.

This Board is in a position to render a distinct service to the public, especially with reference to the simplification of the procedure before the Bureau.

Regulations governing practice before the Treasury.—The Commissioner has issued regulations (Circular No. 230, Form 23) governing the recognition of attorneys and agents and other persons representing taxpayers before the Treasury.

The following extracts from Circular 230 are of interest:

Applicants for enrollment pursuant to these regulations shall submit to the Secretary of the Treasury an application, properly executed, on the form attached hereto (Exhibit A). Applications in any other form will not be considered. Persons members of the bar of a court of record will apply for enrollment as "attorney"; all others will apply for enrollment as "agent." Members of a firm may apply for enrollment either individually or collectively. In the latter case application should be made in the firm name, giving the name of each member and the required information as to each, and the application should be signed in the firm name and by each member of the firm The Secretary of the Treasury may in any case require other and further evidence of qualification. Applicants will be notified of the approval or rejection of their application.

The committee on enrollment and disbarment shall maintain in the office of the chief clerk, Treasury Department, a roll of attorneys and agents entitled to practice before the Treasury Department. It shall likewise maintain lists of those whose applications for enrollment have been rejected and those who have been suspended or disbarred. The chief clerk shall furnish copies of the said roll and lists, with such additions thereto or subtractions therefrom as may be made from time to time, to the bureaus, offices, and divisions of the Treasury Department.

All bureaus, offices, and divisions of the Treasury Department are hereby prohibited from recognizing or dealing with anyone appearing as attorney or agent unless the name of such attorney or agent appears upon the list of those entitled to practice before the Treasury Department. Nothing herein contained shall preclude individual parties or members of firms or officers of corporations from appearing, upon proper identification, as representatives of their own interests or of their respective firms or corporations in any matter before the

department in which such person, firm, or corporation is concerned as a principal; but attorneys, counsel, or solicitors or other agents for such persons, firms, or corporations must be enrolled.

It shall be the duty of the bureaus, offices and divisions of the Treasury Department to ascertain in each case whether the name of one appearing before them in a representative capacity appears on the roll of those entitled to practice. In any case where such enrollment does not appear, the requirement therefor shall be brought to the attention of such representative. The head of such bureau, office, or division may, in his discretion, temporarily recognize such representative pending application for enrollment, provided his name does not appear on the list of those whose applications for enrollment have been rejected or on the list of those who have been suspended or disbarred.

On July 25, 1921, the Commissioner issued the following statement with reference to these regulations:

There is in operation now a new system of enrollment. Applicants are enrolled and certified by a committee, which constantly is functioning for that purpose. They must submit a sworn statement that they are familiar with the laws and regulations of the Treasury Department, and are qualified to act as the representative of others and "render them valuable service." Reply must be given to the question of whether or not they have ever been rejected, suspended or disbarred from appearing as an attorney or agent, or in any other representative capacity, before any branch of the Federal or any State Government, or municipality or court thereof.

Scores of applications are now being held for investigation, which is conducted by field agents of the Bureau of Internal Revenue.

Applicants are required also to state whether they have read and noted paragraph 5 of Treasury Department Circular 230 relating to the recognition of attorneys, agents and other persons representing claimants before the Treasury Department, and especially the following significant paragraph:

"The Secretary of the Treasury regards as unethical any suggestion of acquaintance with officials or prior connection with the Treasury Department."

Supplemental regulations provide that "no attorney or agent shall be permitted to appear in a representative capacity as attorney, or agent before the Treasury Department, or any of the bureaus, departments, divisions, subdivisions, units or other agencies thereof, in regard to any claim, application or re-audit, refund, abatement, reduction in tax assessed, or in any other matter to which he gave actual personal consideration, or as to the facts of which he had actual personal knowledge while in the service of the Treasury Department."

On and after August 1, 1921, power of attorney from the principal in each case will be required of all attorneys, agents or other person representing claimants before the Bureau of Internal Revenue. Such power of attorney must be filed before such agent, attorney or other person is recognized by the Bureau.

These regulations are intended to raise the standard of the practice before the Treasury. Measures of this kind should be encouraged.

Unnecessary examinations.—The following is a new feature of the 1921 law:

LAW. Section 1309. That no taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

Whether or not taxpayers secure relief under the foregoing section depends entirely on the action of the Commissioner. In his sole discretion as many examinations may be made hereafter as have been made in the past.

RETROACTIVE REGULATIONS.—The following section permits the Commissioner to apply new regulations without retroactive effect. The Commissioners have assumed that changes in regulations automatically became retroactive to the effective dates of the laws to which the regulations were applicable.

LAW. Section 1314. That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

If the Treasury should issue regulations interpreting a section of the law and later should change the interpretation

by subsequent regulations, the author is of the opinion that, notwithstanding the foregoing section, a taxpayer overpaying a tax under the first interpretation can force a retroactive application of the latest regulation. If the Commissioner objects, it would be necessary to institute suit. It should be noted that the language of the foregoing section is not mandatory—"subsequent regulations may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect."

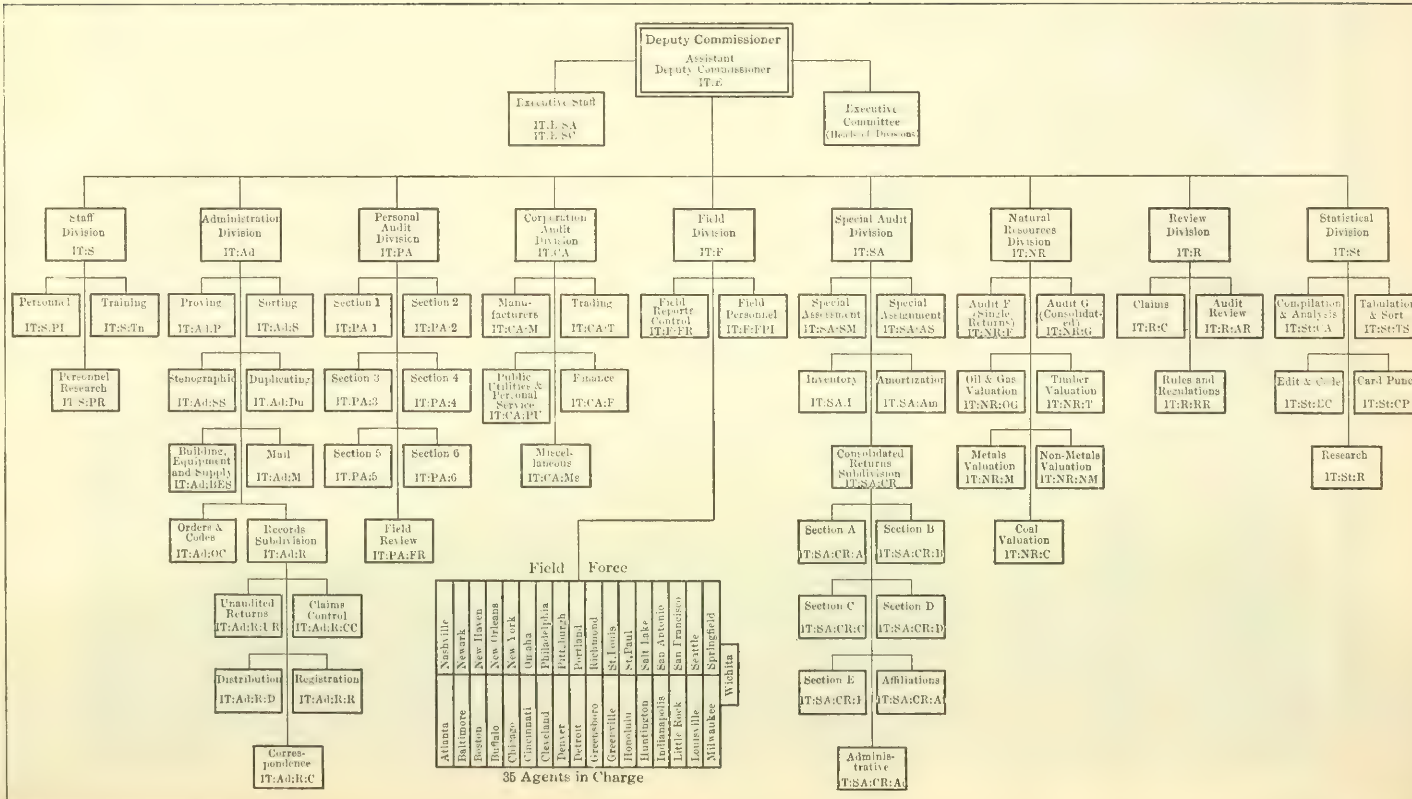
Organization of Bureau.—Those who have dealings with the Bureau will be interested in the organization of the Income Tax Unit, as set forth in the chart reproduced on page 184. Changes are being made from time to time, but the chart is recent enough to be of interest.[10]

The Committee on Appeals and Review is entirely independent of the Income Tax Unit and is responsible only to the Commissioner.

Criticism of overcentralization.—Criticism may be urged against the general organization of the Bureau of Internal Revenue on the ground of overcentralization. At present only the most routine matters can be handled in the offices of the local collectors, all others being carried to Washington for consideration. Uniformity of procedure is, of course, important, but to secure it the present organization sacrifices the convenience of the taxpayer to an unjustifiable extent. Moreover, with the increased volume of the work of the Bureau, due to the wider application of the law since 1917, it is important that decentralization in administration be introduced if intolerable congestion and delay are to be avoided.

At the present time every appeal must be carried to Washington, even though a taxpayer lives on the Pacific Coast. Some method should be devised whereby local hearings could

[10] The chart here was approved Oct. 22, 1921.



Organization of Income Tax Unit

be arranged.[11] This is of especial importance in the case of individual returns. Of course no effort should be made to encourage unfounded claims, but on the other hand nothing should be left undone to give an impartial and patient hearing to all just claims, and the way of the claimant should be made easy rather than hard.

The degree of decentralization which can be adopted depends upon the quality and number of the administrators obtainable for the local work. Large discretion in dealing with important assessments cannot be entrusted to poorly trained or ignorant assessors. At the present time the rewards offered are not sufficient to attract and retain in the service men of the quality needed. Some method of making the career of the government officer attractive must be devised before the income tax administration can be put upon an entirely satisfactory basis.

The following opinion is an argument against decentralization:

> I personally believe the entire review and appeal should be centered at Washington. Large taxpayers, except for those who might desire improperly to influence local collectors, should prefer this method since, in the event of an unfavorable decision before the local officials, an appeal would unquestionably be taken to Washington. In view of the intricacy of income tax questions, local, non-expert boards are unsuited for the work. Even in Wisconsin the local boards of review have no jurisdiction over corporations.[12]

Criticism of the organization and procedure of the Income Tax Unit.—Very little, if any, fault, can be found with the general organization of the Income Tax Unit. The various divisions, subdivisions and sections have been organized along natural lines. The Bureau should be commended for this excellent piece of work.

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[11] Such opportunity was given by the act of 1894, which in this matter took particular pains to make the remedy as inexpensive to the taxpayer as possible (Vol. 25, *Congressional Record*, 6828-6830).

[12] A. E. James, *Bulletin of the National Tax Association*, November, 1920.

The author knows of no changes which should be made in this general plan, but it may be necessary to make a few changes to bring about a simplification of the procedure.

The Income Tax Unit, like most of the government departments, is bound hard and fast by "red tape." The chief fault of the Unit is that there are too many so-called checks and reviews. When one of the checkers or reviewers makes a decision he in turn is checked or reviewed—there are so many checks and they are so numerous and involved that the author is not able to state the number. These numerous checks not only add to the cost of collection, but they cause confusion, displease taxpayers, and destroy the initiative of the employees. Not long ago, it is understood, one of the heads of the sections remarked that he was more interested in having proper checks to prevent fraud than he was in production.

There can be no question about the vital necessity of enough supervision to detect fraud on the part of taxpayers and collusion of one kind or another. It would be highly desirable for the Bureau to lessen the leaks regarding proposed assessments and other information which so frequently appear to be in the possession of so-called tax experts. The connections of each ex-employee who practices before the Department require careful inspection.

The Bureau, no doubt, has thousands of claims which have been pending for over a year on which no definite action has been taken—the Unit is still auditing 1917 returns.

The author makes the following suggestion which he believes will simplify the procedure, speed up the Unit and reduce the cost of collection.

Up to the time when the A-2 letter is issued, which is based either upon an office audit or field examination, no change should be made in the procedure. Precaution should, however, be taken to see that the conferees do not actively participate in the preparation of the A-2 letter, i.e., they should not make decisions on a point in a case which should disqualify them when the taxpayer presents his case.

After an A-2 letter has been issued, if the taxpayer makes a protest against the proposed additional assessment, the case should be referred to the conferees.

All formal conferences should be attended by three representatives of the Bureau: a lawyer, from the Solicitor's office, an accountant, who should be attached to that particular subdivision or section, and an auditor. The lawyer should pass upon the legal points of the case. The accountant should handle all the accounting problems and dispose of them. These two men should co-operate, and many points will have to be passed upon by both. The auditor, in charge of the audit of the case, merely attends the conference so that he may be in a better position to carry out the decisions of the two conferees.

The regulation requiring the filing of a brief (in duplicate and supported by an affidavit of the taxpayer) at least five days before the date for the conference is a good rule and should not be changed. When a taxpayer does not request a formal conference, a brief in duplicate and in affidavit form should be filed before the case is considered by the conferees. Where there are no formal conferences, the three representatives should meet and consider the case as though a formal conference were held.

After a case has been heard and the conferees are convinced that all the facts have been developed, a decision should be announced on all the points involved. This decision should not, however, be announced in conference. A letter should be sent the taxpayer notifying him of the results. This letter would furnish the Bureau auditor with instructions on which to close the case finally.

The procedure of these conferees should correspond with the procedure of a lower court. The chiefs of the sections should have no control whatever over their decisions. The chief should, however, control the assignment of cases for decision. It might be well for each subdivision or section to have a committee of conferees to which cases ready for atten-

tion should be assigned. A head conferee should take care of the assignments. It might even be well to make the conferees an independent organization.

Either the government or the taxpayer could appeal from the decision of the conferees. This appeal should be made to the Committee on Appeals and Review.

The appeal on the part of the government would be made by the Chief of the subdivision or section if he were not satisfied with the ruling. He should, of course, in every case review the decision of the conferees. He should also consult freely with the auditor. After the decision has been announced no appeal should be permitted by either party unless notice thereof is given within say thirty days after the decision was announced.

Claims should be handled in the same manner. The author is of the opinion that all special subdivisions, sections, and review boards handling claims should be abolished. Claims should be assigned to those general subdivisions or sections to which they naturally belong.

Under present procedure many of the conferences and decisions of conferees are farces. Review bodies are permitted to review decisions, and to reverse them without notifying the taxpayer. The taxpayer is not notified of the appeal within the Bureau, hence he is not allowed to appear to present his case. The reviewers do not attend conferences, hence do not hear the oral arguments. This is closely akin to "Star Chamber" proceedings.

Administrative interpretation.—Pending the construction of the statutes by the courts and subject, of course, to such construction, the Treasury is called upon to supply an official interpretation of the law for the guidance of taxpayers.[13] Until the statutes are completely adjudicated, disagreements may always be expected between taxpayers and the Treasury re-

[13] For description of official publications see page 25.

garding the meaning of the law; for, as a matter of policy, the Treasury interprets the law in a strict and narrow fashion. There are large sums continually involved in disputes turning upon close constructions of the law and taxpayers cannot assume that their interests will be adequately protected by a blind conformity to the Treasury rulings. Indeed the system rests upon the assumption that they will not follow the rulings blindly, but will rather contest doubtful points which operate to their disadvantage. This throws a heavy burden upon the taxpayer—one which in some cases is essentially unjust. Especially in the case of minor points which involve relatively small sums, the Treasury should make a reasonably liberal interpretation of the law at the very beginning, because a taxpayer will not contest a trifling matter, but will, nevertheless, smart bitterly if he feels that the Treasury has imposed upon him. Common sense in the interpretation of doubtful points is absolutely essential to successful administration of the law.

In recent regulations there has been evident a very commendable effort to make the interpretation as general and illuminating as possible. Regulations 45 and 62 are superior to their predecessors, Regulations 33 and Regulations 41. Instead of restricting itself to the treatment of a very narrow, particular instance, the Treasury has in most cases essayed a comprehensive treatment of the problem of procedure involved and has not hesitated to enunciate general principles which are to serve as official guides to action by taxpayers.

It must always be remembered, however, that the Supreme Court of the United States is the "last word" on income tax questions—not the Treasury through its regulations and decisions, nor, in fact, Congress. Many acts of Congress dealing with taxation have been held to be unconstitutional and many regulations of the Treasury have been overruled. In this chapter the author covers the procedure *permitted* by the Treasury. In the following chapter the taxpayer's legal rights are discussed.

The following statements, made in two recent cases, are of interest in a consideration of the regulations of the Treasury:

> DECISIONS. The question has been decided both ways in the Internal Revenue Department [Montgomery's *Income Tax Procedure* (Ed. 1918) pp. 231, 232]; and hence the effect usually given to an established practice of an executive department charged with the execution of a statute has no present relevancy. (*United States v. Coulby,* 258 Fed. 27; 169 C. C. A. 163.)

> A practical construction by public officers whose duty it is to enforce a statute is conceded to be entitled to great influence, provided the statute presents an ambiguity which is real and not captious.
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> Where a statute that has been construed by the courts has been re-enacted in the same or substantially the same terms, the legislature is presumed to have been familiar with its construction, and to have adopted it as a part of the law, unless a different intention is indicated; and the same principle is applied to statutes and parts of statutes which have been re-enacted after they have been construed by the legislative or executive departments of the government. (*Edwards v. Wabash Railway Co.,* 264 Fed. 610.)

This is exemplified in the ruling of the Treasury, regarding the allowable deduction for gifts in Regulations 62, article 251, as well as in a letter to attorneys dated August 14, 1919. The basis was stated to be (subject to the 15 per cent limitation) the "fair market value of the property at the time given" in cases of gifts other than money. On the strength of this ruling donations were solicited by universities and eleemosynary institutions which issued tabulations showing the saving in tax resulting from donations of securities as contrasted with donations of cash.

In T. D. 2998, issued in 1920, the Treasury changed its position on this point, holding that the basis must be "cost . . . . or its fair market value at March 1, 1913."

Notwithstanding the official regulation, made in good faith the basis of action, those who made the donations of securities which cost less than their value at time of gift will no doubt be required to pay additional taxes.

POLICY OF THE BUREAU OF INTERNAL REVENUE WITH REGARD TO REQUESTS FOR RULINGS AND ADVICE UPON ABSTRACT PROPOSITIONS.—

RULING. Requests are being received daily for rulings and advice upon abstract cases or prospective transactions involving questions of income tax and profits liability. These requests are so numerous and the insistence on prompt action so great that it seems advisable at this time definitely to outline the Bureau's policy which will govern the consideration of these requests.

The Revenue Acts of 1918 and 1921 depart widely at many points from prior law or practice, and have given rise to new questions of such importance, complexity, and number that the resources of the Bureau are no more than adequate to advise taxpayers promptly of their present liabilities arising out of past transactions. It is impossible to answer every question which the invention or ingenuity of the inquirer may devise without neglecting the fundamental duty of determining tax liability upon the basis of actual happenings. Under these circumstances, the administrative necessity is obvious of giving precedence over abstract or prospective cases to actual cases in which the taxpayer desires to know what are his immediate liabilities under the law.

It will be the policy of the Bureau not to answer any inquiry except under the following circumstances:

(*a*) The transaction must be completed and not merely proposed or planned.

(*b*) The complete facts relating to the transaction, together with abstracts from contracts, or other documents, necessary to present the complete facts, must be given.

(*c*) The names of all the real parties interested (not "dummies" used in the transaction) must be stated, regardless of who presents the question, whether attorney, accountant, tax service, or other representative. (I-2-26; Mim. 2880.)

Administrative efficiency—evasion.—There is no full and trustworthy information concerning the completeness of the income tax assessment. It is a tax which can be evaded, at least for a time, by those who are willing to perjure themselves, but in spite of this there is reason to believe that upon the whole the law is well observed.

The *Annalist,* of December 13, 1920, contained an article purporting to show that approximately as many persons liable to the tax are evading it as are paying it. The data

supporting this contention, although very interesting, are far from definite and conclusive. It was shown that while in 1918 there were 4,409,588 personal returns filed, there were on December 31, 1919, no less than 7,523,664 motor owners in the country. It was shown that, whereas in the District of Columbia there were two and one-half returns for each automobile and in New York one return for each car, in South Carolina there were five automobiles to each income tax return.[14]

Recently the government has prosecuted several taxpayers for making false returns. Out of millions of returns there are sure to be some which are fraudulent. The Treasury should be unremitting in its efforts to punish the offenders. All reputable accountants and lawyers should lend their aid. If it be found that taxpayers have been advised how they can evade the law, the advisors should be indicted and punished as conspirators.

There are, of course, thousands of cases in which there have been differences of opinion as to what is and what is not taxable and as to what is and what is not deductible. The Treasury reverses its own decisions so often that procedure which is allowable one day results in technical "evasion" the next. Moreover, from a rather extensive inquiry, the author has come to the conclusion that in more than half the cases where additional sums were collected by assessments based on examinations the taxpayers made no mistakes whatever in their returns, the assessments being changed by incompetent revenue agents. The additional taxes, which would be classified as evasions, are paid in many cases without protest, *solely* because of the expense and annoyance of bringing suit.

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[14] A very careful study of income has recently been made by the staff of the National Bureau of Economic Research (*Income in the United States*, Harcourt, Brace and Company, 1921). According to their best estimates (page 136), there were in 1918 no less than 5,290,649 persons in receipt of incomes in excess of $2,000. In contrast, there were less than three million income tax returns filed in that year. However, it is not to be concluded that the evasion is as great as might be inferred by these bare figures. "Income" as used in this study was not "taxable net income." It is significant also that 3,065,024 of the 5,290,649 persons, who were in receipt of incomes over $2,000, fell within the group of $2,000 to $3,000. The evasions are probably very largely those of persons just within the income tax paying class.

The great difficulties under which the Treasury labors in securing competent assistants are, of course, apparent. Improvement in the quality of the administration, however, should be made steadily as the law becomes more clearly understood and more fully adjudicated. There is imperative need for better administration if widespread evasion is to be avoided. The heavy rates, coupled with a growing distrust of the Treasury, promise to give rise to a lamentable situation.

Legal effect of changes in form of organization which are made to reduce taxation.—The owners of the stock of a corporation dissolved the corporation and formed themselves into a partnership or trust, apparently in order to avoid paying excess profits tax on a contemplated sale of assets. The Treasury held that the tax nevertheless might be assessed against the corporation on the ground that the transaction was an attempt to evade a tax.

Ruling. A change of form from that of a corporation or association to that of a trust or partnership accompanied by a transfer of capital assets to trustees for the benefit of shareholders followed by a sale of such assets at a price in excess of the cost thereof to the corporation or association, and the distribution of proceeds to the beneficiaries (shareholders), such change being made for the main purpose of avoiding the tax which would accrue to the corporation had the sale been made by it, should be disregarded as a mere sham to avoid assessment of tax against the corporation or association upon the profit derived from such sale, and the corporation or association should be required to return as income any profit derived as though the sale had been made by it directly. (C. B. 2, page 203; S. 1385.)

The taxpayer in the foregoing case appealed to the courts and the opinion of the Solicitor was reversed.[15]

Decision.[16] It is insisted in the opinion of the solicitor for the Bureau of Internal Revenue that this change is a sham and a subterfuge and is ineffective. This same opinion admits the right of an individual or corporation to regulate or change its business with a

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[15] The position taken by the author in this case has been sustained in the court decision above quoted. See *Income Tax Procedure*, 1921, page 444.

[16] *Weeks v. Sibley*, 269 Fed. 155.

view of reducing or avoiding taxation in the future, but in contradiction with this admission holds that the parties involved in this transaction could not do so. Supporting this view there are several cited cases, most of them by state courts. The case of *Pollard* v. *Bank*, 47 Kans. 406, 28 Pac. 202, cited by the solicitor, is directly opposed to his contention. . . . .

Bearing in mind the rule of construction which the Supreme Court announced in the case of *Gould* v. *Gould*, 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211, and numerous other cases, to the effect that the provisions of the taxing statutes are not to be extended by implication beyond the clear import of the language used, and that they are to be construed most strongly against the government and in favor of the taxpayer, it is the opinion of this court that the right to change the status of an organization, or to dissolve an organization in any legal manner, is not made ineffectual because the motive impelling the change is to reduce or avoid taxation in the future. The right so to do is an incidental right inseparably connected with an individual's right to own and control his property. It is practically identical with the sale by a citizen of tax-burdened securities and the investment of the proceeds thereof in tax-exempt ones, for the purpose of reducing or avoiding taxation.

It is not unnatural that any thoughtful business man should take such steps. It is altogether different from tax dodging, the hiding of taxable property, or the doing of some unlawful or illegal thing in order to avoid taxation. . . . .

Assessment

The function of assessing the tax is delegated to the Commissioner.

LAW. Section 1311. [Section 3176, Rev. Stat.] . . . . **The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. . . . .**

The place of the assessment as a step in the administrative process is made clear in the following regulation.

REGULATION. When the returns are received at the collectors' offices they are examined and listed before being forwarded to the Commissioner. As soon as practicable after the returns are received in the office of the Commissioner they are carefully audited in connection with any reports of examination that may have been made by agents of the Department. If error in the amount of tax as stated in the return is detected the tax is recomputed and if the amount is less than that shown in the return the excess will be credited or refunded.

If the amount is greater than that shown in the return the deficiency will be handled as provided in section 250 (d) of the statute and article 1006. . . . . (Art. 1012.)

The returns, or at least the larger ones, are exhaustively audited as soon as practicable [section 250 (b)], but this is usually long after the payment of the tax. If found incorrect, additional tax is demanded. The Commissioner may examine the books of the taxpayer for the purpose of discovering whether or not the net income has been properly reported and the tax liability of the individual or corporation has been satisfied. The auditing and examination of the books is performed by local internal revenue agents who are under the direction of the authorities at Washington, not of the local collectors.

Assessment must be made within four years—exception.— The 1921 law made some radical changes with reference to the period within which the Commissioner may summarily assess the taxpayer on any income he has failed to report.

LAW. Section 250. . . . . (d) The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act or under prior income, excess-profits, or war-profits tax Acts, or of any taxes due under section 38 of such Act of August 5, 1909, shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this Act: *Provided*, That in the case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such de-

cedent: *Provided further,* **That in the case of a false or fraudulent return with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes due:** *Provided further,* **That in cases coming within the scope of paragraph (9) of subdivision (a) of section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision.**

It should be noted that the tax must be both determined and assessed within the limitation period.

LIMITATION PERIOD FIVE YEARS UNDER 1918 AND PRIOR LAWS.—The limitation period of the 1918 law has not been disturbed, but in the case of all acts prior to the 1918 law, the period has been increased to five years. Before this change, the government, notwithstanding the fact assessment could not be made, could bring suit at any time under laws prior to the 1918 act. The 1921 law now provides that neither assessment nor suit under 1918 and prior laws shall be legal after the five-year limitation period has expired.[17]

[17] **[Former Procedure]** Prior to the enactment of the 1921 law, the government under the 1917 law [section 14 (a)] was unable to make assessment and to enforce payment of an additional tax by the usual (summary statutory) proceedings after three years had elapsed since date at which the return was due. It could, however, when it discovered, or alleged that it had discovered, additional tax to be due, bring suit at any time against the taxpayer for the amount alleged to be due. This was a distinct advantage to a taxpayer, because it shifted the burden of proof from himself to the government and made the case altogether different from one in which the government was able to send in a bill, compel payment and put upon the innocent taxpayer the cost of initiating a suit.

The Bureau claims (C. B. 3, page 302; Sol. Op. 79) that if a "discovery" shall have been made within three years from the time the return was due assessment may be made at any time thereafter. Such, however, could hardly have been the intention of the law. The punctuation conveys to the author the very clear meaning that assessments must be made immediately after discovery and the additional tax must be paid upon demand and that the discovery and the assessment must be made within three years from the time when the return was due. Any other construction requires a vivid imagination. As the section covers the imposition of

LIMITATION PERIOD FOUR YEARS UNDER 1921 LAW.—Any tax due under a return filed for the taxable year 1921, or any subsequent year, must be assessed within four years after the return was filed. If, however, any tax is due under any return made under the 1921 law for prior taxable years, the assessment must be made within five years after the return was filed.

The limitation period for taxes under the 1921 law is not the same for assessment and suit. Assessment must be made within four years after the return was filed. Suit or proceedings must be instituted within five years after the return was filed.

LIMITATION PERIOD ONE YEAR IN CASE OF ESTATES.—Section 250 (d) provides, "that in case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, adminis-

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penalties it should be construed in favor of the taxpayer. The United States courts have not specifically passed upon this question. In a suit brought within three years from the time when a return was due (*Eliot National Bank v. Gill,* 218 Fed. 600; 134 C. C. A. 358) the court said that the tax could be assessed after three years if the fact that it was due was discovered within the three years. But the point in question was not before the court, so the statement is *dictum,* and need not be considered a precedent.

It is well settled that where a tax of a fixed percentage is imposed by statute, or is so definitely described in the statute that its amount can be readily ascertained or determined, no assessment need be made in order to recover the tax. In the case of *United States v. Grand Rapids, etc., Railway Company,* 239 Fed. 153, the United States District Court held that the limitation in the statute is a limitation upon the right of collectors to make assessment and to enforce payment by the customary summary proceedings, but does not prevent suit for taxes, which will lie without an assessment. (Judgment affirmed, 256 Fed. 989 [mem.].)

The Treasury has also held the following with reference to the three-year limitation period:

RULING. "1. The extension of time granted by the Commissioner to taxpayers for filing their income returns operates to shift the due date for filing their returns to the expiration of the period of extension; the three-year limitation begins to run from the due date as thus shifted.

"2. Where an excess amount of tax is assessed, the Commissioner is authorized by section 3220, R. S., as amended by the Revenue Act of 1918 to abate the excess amount.

"3. Where the tax assessed is less than the amount due an assessment of the additional amount due can be made, where discovery was made within the three-year limitation period." (C. B. 4, page 325; Sol. Op. 92.)

trator, or other fiduciary representing the estate of such decedent."

A request for determination must be made by the executor. Such an application should be rendered unnecessary by more expeditious handling of returns. This section does not apply to the income of the decedent's estate but only to that received by the decedent during his lifetime.

The one-year period does not apply to suits. The government would have to institute suit within five years after the return was filed.

No limitation period in case of false or fraudulent return.—Where a taxpayer has filed a false or fraudulent return with intent to evade tax, or has failed to file a required return, an assessment may be made or suit instituted at any time.[18]

Limitation period where amortization is claimed or deductions are tentatively allowed.—The following part of section 250 (d) is of especial importance to taxpayers who have filed amortization claims:

Law. Section 250. . . . . (d) . . . . **That in cases coming within the scope of paragraph (9) of subdivision (a) of section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision. . . . .**

It would appear from the foregoing that the Commissioner may, in a case where amortization has been claimed or where the Commissioner has tentatively allowed a deduction, reopen the case to make an assessment or bring suit at any time. The assessment or suit would have to be confined to amortization or to the deduction tentatively allowed. The other limita-

[18] Section 250 (d).

tion periods of section 250 (d) would apply to the other items of the return.

There is an apparent conflict between section 250 (d) and section 214 (a-9). Section 234 (a-8) has the same language as section 214 (a-9). One applies to individuals and the other to corporations.

LAW. Section 214. **(a) . . . . (9) . . . . At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the returns, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252; . . . .**

The rule of law is that a specific section controls a general section. It might be thought that each section is specific. A careful reading shows, however, that section 214 is specific with reference to the deduction for amortization, whereas section 250 is specific with reference to limitation.

Should the courts hold that section 214 governs section 250, the Commissioner would have to re-examine amortization claims before March 3, 1924, but could make an assessment or bring suit at any time thereafter.

LIMITATION PERIOD MAY BE EXTENDED BY AGREEMENT.—A new provision[19] has been added to the 1921 law which makes it possible for the Commissioner and the taxpayer to extend the limitation period with reference to assessment. This provision will no doubt be attacked in the courts if taxpayers should inadvertently sign waivers in ignorance of their legal rights.

Taxpayers should not sign blanket extensions or waivers. The agreements should be carefully drawn. A limitation date should be specifically mentioned.[20]

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[19] Section 250 (d).

[20] In December, 1920, the Commissioner notified many taxpayers that

No limitation period for examination of books.—There is no limitation on the right of the Commissioner or his collectors to examine the books of a taxpayer beyond the five-year period, but no tax can be assessed by the government unless fraud is alleged.

Examination of returns and accounts.—After the original returns are forwarded to Washington, the returns are filed and in due course audited. An audit is made of the return itself and, if necessary, another may be made of the books and accounts of the taxpayer. All of the auditing, whether done in the office or in the field, is under the direction of the Commissioner at Washington.

Field agents, as a general rule, discuss their proposed reports very freely with taxpayers. When the examination has been made by an agent under the immediate supervision of the revenue agent in charge of a particular district, the taxpayer is sent a copy of the report after it has been reviewed by the agent in charge. If an examination is made by an agent directly from Washington, a copy of the report is not furnished the taxpayer. The A-2 letter[21] is the first official notice to the taxpayer of the results of the examination.

Procedure when audit discloses additional taxes due.—If an examination of the original returns or of the accounts of the taxpayer indicates that an additional amount is due, an assessment will be made, unless the taxpayer is able to

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there would not be sufficient time before March 1, 1921, to audit all 1917 returns and asked for waivers. When taxpayers had good reasons to infer that the Bureau would rush through an audit and assess additional taxes without proper investigation (as the letter of the Commissioner intimated would be done), perhaps it was the part of wisdom to relinquish one's legal right and yield to the "hold-up." Those who had no definite knowledge of proposed additional assessments should not have signed the waivers.

There is a serious question as to the validity of waivers executed after the expiration of the three-year limitation. The law does not authorize the Commissioner to extend this period. Furthermore, the consideration cited in the waivers is "unreal." Another criticism of the waiver is vagueness of the persons bound or the promisees. Their identity and authority are not disclosed.

[21] See page 201.

satisfy the Treasury before the audit is closed that an error has been made by the inspector. The taxpayer may prepare a statement of all relevant facts, furnish one copy to the inspector with a request that it be forwarded to the Treasury and send another copy, with affidavit attached, to the personal or corporation audit department of the income tax unit at Washington. This does not constitute an amended return, but is merely a presentation of the case of the taxpayer for consideration by the audit section, which will also have before it the report of the inspector. If the taxpayer does not feel that his statement, unsupported by oral evidence, is sufficient, he may in the statement forwarded to Washington request a hearing and an opportunity to submit additional evidence if it should appear to the audit section that an adverse report is likely to be made. If this request is filed the taxpayer will be granted a hearing in person or by attorney before any additional tax is assessed against him. After the hearing a decision will be made by the audit section from which an appeal can be taken, as herein after explained.

A-2 LETTER.—If after the Treasury has made an examination of a taxpayer's return (either office or a field audit) it appears that an assessment is required, a letter, which the Treasury has designated as the "A-2 letter," is sent notifying the taxpayer that an examination shows that he is liable for an additional amount of tax.

The new law [section 250 (d)][22] requires that the taxpayer must be notified by registered mail.

The A-2 letter not only states the amount of the tax, but also sets forth the reasons for it. The amount of detail given varies, some letters giving very full details of adjustments and computations, others giving only meager details. The letter also notifies the taxpayer that if he does not, within thirty days from the date of the letter, file an appeal and show cause

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[22] See page 208.

or reason why the tax should not be paid, the collector of his district will notify him in due course as to the time and manner of making payment. The letter usually concludes with a paragraph similar to the following:

In accordance with the Revenue Act of 1921, you will be given thirty days to present any exceptions to the additional assessment referred to in the enclosed letter, and to show cause or reason why the same should not be paid. This may be done either by way of a sworn statement of facts and exceptions submitted within thirty days from the mailing date of the attached letter, or at a conference, which may be arranged upon request, for a date prior to the expiration of the 30-day period.

The foregoing notice, while it usually mentions a thirty-day period, is not intended to cover the thirty-day period mentioned in the law. Therefore, if the taxpayer believes that the proposed assessment, or any part thereof, is erroneous, he should immediately take proper steps to protest against it.

Section 250 (d) of the new law reads as follows:

LAW. Section 250. . . . . (d) . . . . **If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained:** *Provided,* **That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing. . . . .**

The following ruling indicates the procedure which should be followed when a taxpayer receives an A-2 letter or any kind of a notice showing a proposed additional assessment.

REGULATION. Section 250 (d) of the Revenue Act of 1921 provides that if upon examination of a return made under the Revenue

Act of 1916, 1917, 1918, or 1921, an income or excess profits tax or a deficiency therein (which deficiency is defined in section 250 (b) as meaning the difference, to the extent not covered by any credit due to the taxpayer under section 252, between the amount of the tax already paid and that which should have been paid) is discovered the taxpayer shall be notified thereof and shall have the right of an appeal and a hearing before an assessment is made. As soon as practicable, therefore, after a return is filed, whether by the taxpayer or as provided in section 3176 Revised Statutes, as amended, it is examined, and if a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof by letter in which he shall be given a reasonable time in which to protest and file exceptions specifying the reasons why the tax or deficiency should not be assessed.

(*a*) If the taxpayer protests against the proposed assessment after the first notification by mail as above set forth, he will present his exceptions in writing to the income tax unit in Washington or to the division thereof where the said proposed assessment is being considered. Such exceptions must state fully the facts and grounds upon which the taxpayer relies. A reasonable additional time in which to file other data in support of the taxpayer's contentions may be allowed upon request showing cause for such extension. A hearing by the income tax unit shall be granted the taxpayer if requested by him; if no hearing is requested a decision will be made by the income tax unit upon the written data submitted. Whether a hearing is had or not a decision shall be made by the income tax unit at the earliest practicable date and the taxpayer notified thereof. The notification of the decision of the income tax unit shall be made by registered mail and a period of not less than thirty days given the taxpayer in which to file an appeal to the Commisisoner and show cause or reason why such tax or deficiency should not be paid. Full thirty days from the mailing (not the receipt) of such notice to file an appeal shall be given the taxpayer. The appeal must be filed in the office of the Commissioner in Washington within thirty-one days from the mailing of the notice, but if it is mailed in time to be received by the Commissioner within such period in the ordinary course of the mails it will be considered as having been filed within such period. No particular form of appeal is required, but the appeal must set forth specifically the exceptions upon which it is taken. The appeal shall be under oath and must contain a statement that it is not taken for the purpose of delay. Opportunity for a hearing shall be granted if requested within a reasonable time. The taxpayer in his appeal may rely upon the data previously submitted, or he may obtain a reasonable extension of time if cause therefor is shown in which to file additional data, evidence or argument. Such request shall be under oath and must state specifically the reasons for additional time. When a decision has been made by the proper officer, employee or employees of the bureau and

approved by the Commissioner, an assessment, if any, shall be made forthwith in accordance with the terms of such decision.

(*b*) If the taxpayer does not protest within the time fixed by the first notification by mail, then and in that case the proposed assessment shall be the decision of the income tax unit and the taxpayer shall be notified thereof. This notification of the decision of the income tax unit shall be made by registered mail and a period of not less than thirty days given the taxpayer in which to file an appeal to the Commissioner and to show cause or reason why such tax or deficiency should not be paid. The procedure on said appeal shall be the same as in the case of an appeal to the Commissioner as provided in (*a*) above.

In the case of a return which is examined in the collector's office where a tax or deficiency of tax is discovered and notice of the proposed assessment is sent out by the collector, the procedure shall be the same in said collector's office as herein provided for in the income tax unit. The decision of the collector may be appealed from, which appeal shall be to the Commissioner at Washington, and shall follow the same procedure as provided for in (*a*) or (*b*) above.

No assessment under section 250 (d) shall be made without notification to the taxpayer of his right to appeal and show cause, except that in any case where the Commissioner believes that the collection of the amount due will be jeopardized by delay, he may make the assessment without giving such notice or awaiting the conclusion of a hearing.

Where a taxpayer has been given an opportunity to appeal and has not done so, as above set forth, and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement of the assessment shall be entertained.

Where an assessment has been made without giving the taxpayer an opportunity to appeal or without awaiting a decision on an appeal that has been perfected, a bona fide claim in abatement of the assessment, filed within ten days after notice and demand by the collector, may be entertained. (Art. 1006.)

The author is of the opinion that the foregoing regulation brings about a greater delay than was intended by Congress. It is probable that the procedure will be changed so that the first notice may be sent out by registered mail, and thus meet the requirements of the statute. Under the present ruling, it would appear that a taxpayer may ignore the first notice and wait for the second notice which entitles him to fight the case out before the Committee on Appeals and Re-

view, which body acts for the Commissioner. This should not and probably will not be permitted. If the taxpayer does not file his protest within the first thirty-day period, it will not be unreasonable that the assessment be made. In other words, taxpayers who do not protest at once should not be entitled to the second notice provided for by the foregoing ruling. To accomplish this, the first notice would have to go out by registered mail.

In order to stop the assessment of the proposed tax, the taxpayer must (1) file his protest within thirty days from the date the notice was sent, and (2) the protest must show the cause or reason why the tax should not be paid. In most cases the taxpayer will wish to take the matter up in conference. In such cases a request should be made for an oral hearing.

The protest should also make a specific demand for a hearing before the Committee on Appeals and Review if the decision of the Income Tax Unit, or any part thereof, is adverse to the contentions of the taxpayer.

In many cases, especially where the amount involved is very large, it will not be possible to file a complete brief taking up in detail the proposed assessment. In such cases, it should be sufficient, as is contemplated by article 1006, to file the formal protest within thirty days, setting forth the items which will be contested and the reasons in a general way why the tax should not be paid. These reasons should not be too general, but should be specific enough to enable the Treasury to decide whether or not the contentions are meritorious.

Taxpayers should make all protests in good faith and as soon as practicable. This will encourage a fair administration of the law. Taxpayers should request reasonable extensions of time in which to prepare properly the details of their cases. In all complicated cases an oral hearing should be requested, since the questions involved are of the same nature as in litigated cases and no one would think of taking a case into the courts and of waiving the right to a trial before a judge or a jury.

After a case has been heard by the Income Tax Unit, an appeal lies to the Committee on Appeals and Review before the assessment is made.[23] While the law and article 1006 do not state that notice of intention to appeal to the Committee must be given within the thirty-day period, the safest procedure is, as suggesed above, to give such notice at the time of filing the formal protest.

Since the language of article 1006 is somewhat involved, the following analysis may prove helpful:

I. Abatement claims may be filed only in the following cases:

(a) When the taxpayer is not notified of the *intention* of the Treasury to make an additional assessment; and the Treasury does not send notices by registered mail. It is not likely that assessments will be made unless notice is given.

(b) If the taxpayer has appealed to the Commissioner of Internal Revenue, or has had a hearing before the Commissioner or his representatives, or has filed objections and has had a hearing, and pending the promulgation of the Commissioner's decision, the proposed assessment has nevertheless, been made.

(c) If unable to pay.

II. Taxpayers are to be notified by mail that, as a result of the examinations of their returns, the government finds that additional taxes are due. Thereupon,

(a) The taxpayer has a right to file exceptions to the proposed assessment, and also

(b) The taxpayer is entitled to a hearing before the Income Tax Unit.

A reasonable time will be afforded taxpayers in which to file their exceptions or to ask for a hearing or to do both. There is no statutory time. The Treasury will probably suggest a fixed time, probably thirty days, and give taxpayers additional time if circumstances warrant.

III. If the taxpayers exercise the right referred to in II above, and submit their objections,

(a) A decision is made either on the basis of the taxpayer's original data, or on the basis of the taxpayer's written

[23] For procedure before Committee on Appeals and Review, see page 175 *et seq.*

presentation, or on the basis of his oral presentation, or on the basis of both presentations.

(b) The decision of the Unit must be communicated to the taxpayer by *registered mail.*

(c) Thereupon, the taxpayer has thirty days in which to appeal to the Commissioner from the decision. This appeal must be in writing. After the filing of the appeal, an oral hearing may be had.

(d) The assessment, if any, is thereupon made and this decision is final.

IV. If taxpayers fail to exercise the right referred to in II above,

(a) The decision of the Unit must be communicated to the taxpayer by *registered mail.*

Thereupon, the procedure is as in III above and the result is as in III (d), above.

V. If the collector's office discovers apparent cause for an additional assessment, the collector notifies the taxpayer whose procedure thereafter may be either as outlined in II or in IV above.

VI. When the assessment is made, no abatement claim with reference to such assement may be filed, except in the specific instances indicated in I above.

If taxpayers, after receiving notices of proposed additional assessments, file appeals within the specified time, assessments cannot be made until hearings have been granted and final decisions are made.

After final decisions are made, or if appeals are not made within the specified time, the proposed assessments are included in the next list sent to the collector.[24] Upon receipt of the lists, the collector issues notice and demand for payment as soon as possible. The tax must be paid within ten days after notice and demand. The collector cannot accept a claim for abatement.[25] If the taxpayer still wishes to contest the assessment, a claim for refund may, however, be filed immediately after payment is made—a procedure which is necessary in order to

[24] Lists are usually sent to the collectors about the 19th of each month. Sometimes, however, a special list is sent.

[25] See page 202.

file suit.[26] Under all circumstances payments should be made under protest.[27]

Section 250 (d) provides that in cases where the Commissioner believes that the collection of the tax will be jeopardized by the delay due to the appeal, he may make the assessment without giving notice or awaiting the conclusion of a final hearing. In such a case, if the collector will accept it, a claim for abatement may be filed.[28] If a claim is accepted, the collector will no doubt require a bond or security. The merits of the case would then be fought out under a claim in abatement. If the collector refuses to accept a claim in abatement, the tax must be paid and a claim for refund filed.[29]

Can assessments be made if taxpayer has not been properly notified?—The 1921 law provides that in the case of an additional assessment:

LAW. Section 250. . . . . (d) . . . . the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal. . . . Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. . . . .

The foregoing section applies to the 1916, 1917, 1918, and 1921 laws. Therefore, any assessment made after November 23, 1921, the date of enactment of the 1921 law, is illegal if the above section has not been followed.

No doubt there were many assessments in the hands of collectors and still others ready to be sent to collectors by the Commissioner under the old procedure when the 1921 law was approved. These proposed assessments cannot legally be made until the Treasury has complied with section 250 (d).

Additional assessments bear interest.—Prior to the enactment of the 1921 law, additional assessments did not bear in-

[26] See page 263.
[27] See page 286 *et seq.*
[28] See page 202.
[29] *Ibid.*

terest unless they were not paid within ten days after receipt of notice and demand from the collector. Under the new law, the assessment bears interest from the date the tax was due.

LAW. Section 250. . . . . **(b) . . . . If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (hereinafter called "deficiency"), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due), shall be paid upon notice and demand by the collector. . . . .**

The foregoing provision applies only to returns for 1921 and subsequent years.

Assessment when consolidated returns are filed.—The new law continues the right given corporations making consolidated returns by the 1918 law, to elect in what proportions the tax shall be assessed against each corporation in the group.

LAW. Section 240. . . . . **(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.**

The foregoing formula for apportionment of taxes when consolidated returns for 1917 are filed by corporations and partnerships is modified in the following:

RULING. It is held, therefore, that where corporations and partnerships are consolidated the excess profits tax should be allocated to the partnerships as a group according to the invested capital and net income assignable to the partnership group. After the proper amount of the excess profits tax has been allocated to the partnership group, article 78 may then be applied within the partnership group as it is now applied within the corporation group. (B. I-3-37; L. O. 1083.)

Final determination and assessment.—The 1921 law provides that a case, under certain conditions, may be finally de-

termined, thus overcoming the uncertainty which has heretofore existed as to when a tax case was actually closed.

LAW. Section 1312. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

The foregoing applies to all the various kinds of taxes. A question may arise as to whether this section applies only to the 1921 law. The language is broad enough, however, to cover all previous laws.

To bring about such a final determination, there must be (1) an agreement in writing between the taxpayer and the Commissioner, and (2) the agreement must be approved by the Secretary of the Treasury. In case of a corporation a certified copy of the minutes of the board of directors authorizing an officer to sign the agreement must be filed with the Treasury. The agreement should be executed in duplicate. (See article 1141).

Aside from the general question as to whether the foregoing section is constitutional, a question may arise as to its breadth. What is meant by "after a determination and assessment *in any case* . . . . *the case* shall not be reopened?" What do the words "in any case" and "the case" include?

Generally speaking, the words "any case" or "the case" include only those particular questions under consideration. Such an interpretation would make invalid any agreement between the taxpayer and Commissioner to the effect that no question would be raised by either with reference to the tax return for any particular year or years. The law does not refer to tax returns or years.

Webster's Dictionary defines the word "case" to mean:

> "The matters of fact or conditions involved in a suit, as distinguished from the questions of law; a suit or action in law or equity; a cause."

Under the synonyms of the same dictionary appear the following:

> "Case made, Law, a case stated submitted to the court for a decision on the law without previous proceedings."
>
> "Case on appeal, Law, the statement which an appellant lays before the court for the prosecution of his appeal as the presentation of the facts on which the appeal is based."
>
> "Case stated, Law, an agreed statement of facts made for presentation to a court in order to obtain a decision of law upon the facts stated."

Against the foregoing definitions are the facts which confronted Congress when this section was written. Taxpayers have complained that they never know that their tax cases, meaning tax returns, have been finally closed. Arguments have been advanced that this fact has prevented many business transactions. It is possible that Congress realized that the subject of such a broad agreement would be too indefinite and vague, and therefore not legal.

Final determination of claims.—It is difficult to distinguish the following provision from section 1312:

LAW. Section 1313. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal-revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.

The foregoing section falls under that division of the law which Congress terms "Administrative Review." It is the

only section under this division and follows immediately section 1312. The language of section 1312, which states that "the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States," should be broad enough to stop all administrative review.

It is possible, notwithstanding the heading, that Congress intended this section to apply only to claims filed by the taxpayer. Section 1312 is confined to "a determination and assessment in any case the taxpayer has without protest paid in whole any tax . . . . , ... or accepted any abatement, credit, or refund based on such determination and assessment." It is possible that section 1312 is intended to apply to cases initiated by the government, and section 1313 to cases initiated by the taxpayer.

It is significant to note that the conference committee inserted the word "other" immediately before the phrase "administrative officer, employee, or agent of the United States."

Procedure to reopen a case.—The following ruling applies to cases which have been finally settled by the Treasury. It does not apply to cases closed under sections 1312 and 1313 of the new law.

RULING. Where any case in the Bureau of Internal Revenue has been finally closed after the taxpayer, or other party thereto, has had a hearing or has been afforded by written notice an opportunity to present oral or written arguments or statements of fact in support of his contentions, the case will not be reöpened except (1) where a showing is made of new and material facts, accompanied by an explanation, satisfactory to the Commissioner of Internal Revenue, of the failure to produce such facts prior to the closing of the case, or (2) where the case is materially affected by the change of regulations or by the final decision of another case either by the Commissioner of Internal Revenue or by a court of competent jurisdiction. The application for reopening a case should be addressed to the Commissioner of Internal Revenue, should state succinctly the facts and circumstances upon which the application is based, and must be supported by the affidavit of a person having knowledge of the facts.

This decision is not to be construed as modifying the regulations

relating to the filing of claims in abatement or claims for refund, nor as denying the right of a taxpayer to a hearing or to an appeal at any stage of his case until the case has been finally closed. After the taxpayer has exhausted his remedies within the Bureau, however, and the case has been finally closed, it will be reopened only under the conditions stated in the decision. (B. 46-21-1927; T. D. 3240.)

Procedure in cases arising prior to T. D. 3269.—Prior to the passage of the 1921 law (November 23, 1921) and the issuance of T. D. 3269,[30] it was contrary to the policy of the Treasury to permit an appeal to Committee before assessment. That is, a proposed assessment was not withheld pending an appeal. Consequently, there are many cases pending before the Committee on Appeals and Review. There are others which have been assessed and formal appeal not yet made. The present procedure should not affect any of these cases.

Taxpayers were advised to file claims in abatement pending an appeal,[31] and collectors should be notified by the Secretary of the Treasury to postpone any action looking to collection until final decisions by the Committee are handed down.

Claims procedure should be revised.—The word "claims," as used above, includes claims for abatement, refund, and credit.

The procedure of the Treasury should provide for an orderly appeal to the Committee on Appeals and Review in cases where the Unit has ruled adversely on a claim. Heretofore in the case of claims for abatement and credit, taxpayers did not know that their claims were denied until collectors demand payment.

In view of the provisions of the 1921 law, all decisions of the Unit should be sent to taxpayers and their right to dissent and appeal made clear.

A rule should be made that taxpayers should be notified by letter that the Unit has rejected their claims and that they

[30] This Treasury Decision now appears as Art. 1006, page 202.
[31] C. B. 4, page 370; O. D. 709.

have, say, thirty days, to give notice of appeal to the Committee. If notice of appeal is not filed, collectors may reasonably demand payment in case of rejected claims for abatement or credit.

Until such a rule is promulgated, taxpayers should notify the Treasury when claims are filed that if the decision of the Unit is adverse, the right of appeal to the Committee is requested before the claims are formally rejected.

Summary proceedings in case of contemplated evasion.—

LAW. Section 250. . . . . (g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment

of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes.[32] In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdivision there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due. . . . .

Congress wisely empowered the Commissioner, in cases of intent to evade, to declare all taxes to be due and payable.

PERSONS GOING ABROAD MUST PRESENT CERTIFICATES OF COMPLIANCE.—

RULING. In order to obtain income tax clearance, American citizens planning to leave the United States are required to present their certificates of compliance or receipts showing payment of income tax, at the office of the internal revenue agent in charge at the port of embarkation, rather than to the internal revenue agent at the pier. (C. B. 3, page 301; O. D. 666.)

The new law gives the Commissioner power to waive this requirement as to citizens of the United States.

Collectors have attempted to collect instalments not due from citizens going abroad for a short time. The law was intended only to reach those who attempt to evade payment, and collectors are not empowered to impose unreasonable requirements.

Aliens departing from the United States must present evidence that they have satisfied their income tax obligations. Detailed procedure is set forth in Chapter XXXVI, "Non-Resident Aliens." Many aliens when leaving the United States are classed as non-residents.

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[32] The portion of this subdivision following this point was added to the provision of the 1918 law.

CERTIFICATE OF COMPLIANCE.—

RULINGS. Certificates of compliance with income tax obligations may be procured either from the office of a collector of internal revenue or from the branch office of the collector within the same collection district. The deputy collector or revenue agent acting for the collector will issue the certificates. (C. B. 1, page 252; O. D. 324.)

Inasmuch as this office has not prescribed a form of certificate of compliance for the use of resident aliens, a letter or statement from the collector is acceptable to show to the revenue agent at the port of embarkation that the resident alien has satisfied all income tax obligations up to date of departure. The letter or statement should set forth the facts that the alien is a subject of (insert name of country), that he is a resident of the United States, satisfactory proof of such claim of residence having been submitted, that he has satisfied all income tax obligations for the years 1918, 1919, 1920, and up to date of departure and has satisfactorily proved to the collector that his absence is to be only temporary. This statement should be attached to the duplicate Form 1040-A issued to the alien to be presented to the revenue agent at the port of embarkation. The duplicate Form 1040-A should contain a notation by the examining officer in the collector's office to the effect that the alien is a resident leaving the United States for a temporary visit abroad. (C. B. 4, page 329; O. D. 840.)

The servants of a diplomatic representative of a foreign country should not be examined for income tax purposes when such servants accompany the diplomat upon his departure from the United States. (C. B. 4, page 329; O. D. 812.)

CONSULAR RECEIPTS ACCEPTABLE.—

RULING. Consular receipts showing payment of United States income taxes through a United States consulate by citizens of this country residing abroad will be accepted by revenue agents at ports of embarkation as evidence of satisfaction of income tax obligations in the case of departure of such citizens who are temporarily in this country. (C. B. 2, page 244; O. D. 500.)

Payment

Payment may be made in instalments.[33]—The 1921 as well as the 1918 law permits the taxpayer either to divide his tax

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[33] The payment of the excess profits tax is made in exactly the same manner as the income tax. (See section 336.)

into four instalments, spread evenly throughout the year,[34] or to pay it in a lump sum at the time of filing the return.

LAW. Section 250. (a) That except as otherwise provided in this section and sections 221 and 237 [payment at the source] the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return,[35] and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as a part of such installment interest thereon at the rate of ½ of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension. . . . .

It should be noted particularly that the extension of time for filing the return ordinarily operates to extend the time of payment of the first instalment only.[36]

RULING. Where an understatement of the tax in a return is not attributable to negligence or fraud and a taxpayer accordingly fails to pay at least one quarter of the tax due at the time for filing the return, he does not lose his right to make installment payments. (C. B. 4, page 317; O. D. 961.)

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[34] [Former Procedure] Under the 1909 and 1913 laws the tax was due June 30; under the 1916 and 1917 laws the tax was due June 15.

[35] The fifteenth day of the third month following the close of the taxable year—March 15 in case the calendar is used.

[36] [Former Procedure] Extension of time for making a return formerly did not operate to postpone the payment of the tax. If an extension carried beyond the regular date of payment, the tax was payable "upon notice and demand." (Reg. 33, 1918, Art. 230.)

Notice of payment due.—The law states that the tax "shall be paid" at dates fixed by section 250 (a) quoted above, but penalties cannot be imposed until notice and demand has been made in accordance with the following:

LAW. Section 250. . . . . **(e) . . . . In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be sufficient notice of the amount due. In the case of each subsequent installment the collector may, within thirty days and not later than ten days before the installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment. Such notice of the collector shall be sufficient notice and sufficient demand under this section. . . .**

Subdivision (h) of this section makes this change retroactive with respect to the 1917 and 1918 laws.

The foregoing is an enactment of T. D. 3136[37] in which the 1918 law was erroneously interpreted. This section of the law was intended to cure one of the known defects of the 1918 law which the Department attempted to change by regulation.[38] The author knows of at least one case where payment was withheld in order to test the regulations, but the Department would not assess the penalty.

There is no advantage in waiting for notice from the collector on the second and third instalments. Subdivision (a) of section 250, which fixes the dates when the instalments must be paid, provides that "if any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector." In the case of the fourth instalment the taxpayer can postpone payment until he receives notice in accordance with section 250 (e). No penalty or interest can be assessed until proper notice has been given.

ADDITIONAL NOTICE IN CASES OF ABSENCE.—The Treasury recognizes that "by reason of absence in foreign countries

[37] C. B. 4, page 316.

[38] See *Income Tax Procedure*, 1921, for procedure under 1918 law, pages 178-183.

or on account of traveling abroad, or of absence from their homes or places of business in the military or other service of the country, and the consequent delay in receiving mail, it is impossible for many individuals to receive notice and demand on form 17 and make payment of the taxes assessed thereon so that such taxes can be received by the collector within the ten-day period." In such cases additional time is allowed.

Regulation. . . . . By reason, however, of the absence from home or place of business in a foreign country or in the military or other service of the country and the consequent delay in receiving mail, or by reason of the location of the residence of an individual or of the office of a corporation to which the notice was addressed at a distance from the collector's office, it is frequently impossible for a taxpayer to receive notice and demand and to make payment of the tax so that such payment may be received by the collector within the 10-day period (following the service of notice and demand). In all such cases the collector will enter on the notice as the date on which the tax becomes due and payable a date as nearly as possible 10 days after the time that the notice should be received in the ordinary course of the mails by the taxpayer. In such cases where it is established that a remittance for the tax was placed in the mails within the 10-day period after the due date specified in the notice, and tardiness was occasioned because the notice was not delivered in due time by reason of delay in the mail and satisfactory evidence of that fact is furnished, the penalty and interest will not be collected. (Art. 1007.)

A few immaterial changes have been made in this article.

Ruling. A taxpayer having filed his return and paid the first installment of tax is aware of his liability to pay the balance of the tax on the respective due dates, and failure to receive notice and demand for the payment of the later installments by reason of his absence from this country does not constitute a sufficient cause for waiving the penalty and interest on any installment of the tax not paid when due. (C. B. 2, page 236; O. D. 408.)

Notice required in all cases.—It appears that some collectors are too arbitrary in their demands for additional returns, collection of additional taxes, etc. Taxpayers may be assured that precipitate action is illegal. Reasonable notice of any proposed action must be given or the act is illegal, because

it is in violation of the constitutional guarantee of due process of law.[39]

The courts have held that as a general principle of law a proceeding for the assessment of property for taxation is judicial in its character, and in order to assure its validity the law authorizing it must provide some kind of notice.[40]

The law binds the Commissioner and the collectors to give ample notice of all proceedings, including the imposition of penalties. The notices must allow sufficient time to the taxpayer to produce evidence supporting his original returns, or to pay within the statutory time of 10 days after formal demand.

METHOD OF CALCULATING INTEREST.—

RULING. (a) Where interest is collectible at the rate of 1 per cent per month from the due date interest must be collected for the fractional part of a month where the tax is not paid within 10 days from notice and demand for payment.

(b) Under sections 502, 504, 629, 903, and 905,[41] interest is collectible at the rate of 1 per cent for each full month, and fractional parts of a month must be disregarded.

(c) Interest is collectible from the month tax becomes due. (C. B. 1, page 244; O. 884.)

Who pays the tax when a corporation liquidates?—The question as to who shall pay the tax in case a corporation is dissolved is satisfactorily answered in the following regulations:[42]

REGULATIONS. A corporation going into liquidation during any tax period may, at the time of such liquidation, prepare a "final re-

[39] See Alex. M. Hamburg, "Limitations upon the Federal Taxing Power," 3 *National Tax Association Bulletin*, pages 34-39.

[40] *County of Santa Clara v. Southern Pacific Railway Co.*, 18 Fed. 385; judgment affirmed, 118 U. S. 394; 30 L. Ed. 118; 6 Sup. Ct. 1132.

[41] Section 502 relates to taxes due on transportation and telegraph, etc., service; section 504, to taxes due on insurance policies issued; section 629; to taxes due on soft drinks; sections 903 and 905, to taxes due on luxuries.

In the detailed ruling by the Treasury, it is stated: "Heretofore this office has held repeatedly that no interest for a fraction of a month shall be demanded."

[42] See also C. B. 4, page 262; O. D. 768. Also C. B. 4, page 279; O. D. 821.

turn" covering the income received or accrued to it during the fractional part of the year during which it was engaged in business, and immediately file the same with the collector of the district in which the corporation has its principal place of business. Before distributing its assets, a dissolving corporation should reserve funds sufficient to pay any income tax assessable against it. Otherwise the tax may be collected by suit against the stockholders. (Reg. 33, 1918, Art. 612.)

When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. . . . . (Art. 548; Reg. 45, Art. 547.)

A federal court[43] has recently held that collection by distraint, of taxes assessed by a collector ex parte against a long since dissolved corporation, the business being continued by the former stockholders as a partnership (Pennsylvania), and the property against which the collector is proceeding being that of the partnership, may not be enjoined by the members of the partnership, they being taxable persons and the property itself being such as to be liable to distraint for any tax assessed against them.

It was held that a corporation which liquidated in 1917 before the passage of the 1917 law was nevertheless liable to taxation under that law.[44] Similarly the Treasury expressly declared that a corporation liquidating in 1918 or early in 1919 was subject to the rates imposed by the new act of 1918, even though it was not passed until 1919.

Regulation. . . . . A corporation which was dissolved in 1921 prior to the enactment of the present statute is not relieved from the necessity of rendering returns thereunder for such portion of 1921 as elapsed before its dissolution. . . . . (Art. 621.)

It is, of course, important to consider the liability for taxes whenever a corporation liquidates, but it is difficult to provide for a liability so uncertain as subsequent tax legisla-

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[43] *Markle et al. v. Kirkendall,* 267 Fed. 498.
[44] *U. S. v. McHatton et al.,* 266 Fed. 602.

tion. In *Brady v. Anderson*[45] the estate was not settled when the law of 1913 was passed. But a corporation which dissolved, say, in February, 1918, could hardly foresee the exact liability to be incurred under a law which was not passed until a full year later. In the meantime the corporation might have dissolved as it had a legal right to do. It was willing to set aside all taxes accrued under existing laws. To assess a tax in 1919 under a law passed in February, 1919, on a corporation which was dissolved in February, 1918, would certainly appear to be reviving a dead corporation.[46]

RULING. Where a corporation dissolves and disposes of its assets without making provision for the payment of its accrued Federal income tax liability for the tax follows the assets so distributed, and upon failure to secure the unpaid amount suit to collect the tax should be instituted against the stockholders and other persons receiving the property, except bona fide purchasers for a valuable consideration. The penalties prescribed in section 253 of the Revenue Act of 1918 will attach to the principal officers of the corporation upon failure to comply with the provisions of that section. (C. B. 3, page 300; O. D. 597.)

The foregoing conforms with a recent court decision.

Stockholders of a corporation, who received in distribution the entire proceeds of its property on its dissolution in 1916, after payment of its federal excise tax, but before the passage of the Income Tax Act of September 8, 1916, increasing the amount of the tax on the net income of all corporations for that year, were *held* liable for the increased tax.[46]

A stockholder received a liquidating dividend in 1917. It was found that the distribution was excessive because federal taxes had not been sufficiently paid. Held, that the stockholder may file an amended return for 1917 deducting the assessment paid in 1920. (I-3-27; I. T. 1164.)

Receivers personally responsible—when?—In the case of *Pennsylvania Cement Company* and *Bradley Constructing*

[45] 240 Fed. 665; 153 C. C. A. 463.
[46] See "Retroactive legislation," page 21.
[47] *U. S. v. McHatton*, 266 Fed. 602.

Company (274 Fed. 1003), receivers were directed not to declare a dividend to creditors before federal taxes had been adjusted, because they could be held personally responsible for the taxes under sections 3466 and 3467 of the Revised Statutes.

Delinquent assessment payable "upon notice and demand."—

LAW. Section 250. . . . . **(c) If the return is made pursuant to section 3176[48] of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector. . . .**

Erroneous or illegally assessed taxes must be paid.—In all cases it must be remembered that the tax levied by the collectors must be paid if (after an appeal to the Commissioner) the assessment is confirmed, even if it is clearly in error. The United States Supreme Court has held that Congress has afforded a complete and adequate remedy at law open to all persons aggrieved by the collection of an erroneous or illegal revenue tax, and that the taxpayer must pay the tax and may then bring an action to recover it after appeal.

The Supreme Court has affirmed this old rule under the income tax laws. In a fairly recent case[49] the court reiterated the provision in section 3224, Revised Statues, that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court."[50]

In a pending case in Delaware a taxpayer is attempting to enjoin a collector from collecting a tax imposed for the year 1915, on the ground that no assessment was made or suit commenced prior to March 1, 1921, that date being five years after the 1915 return was filed.

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[48] Section 3176 deals with the subject of false and fraudulent returns and is quoted on page 136.

[49] *Dodge v. Osborn, Commissioner* 240 U. S. 118; 36 Sup. Ct. 275; 60 L. Ed. 557 (February 21, 1916).

[50] See page 250.

Media of payment.—

PAYMENT MAY BE MADE BY MAILING UNCERTIFIED CHEQUES.—Taxes may be paid to the collector by cheque and should be mailed at least a day or two before the date fixed for payment. During the last few days of the payment period many taxpayers pay in person at the offices of the collectors, and this causes congestion and long delays. The use of the mails is, therefore, preferable and is on the whole trustworthy.

Until the enactment of the 1917 law, practically all taxes were paid by certified cheques. The law[51] now authorizes the collectors of internal revenue to accept uncertified cheques in payment of income and excess profits taxes. Cheques should be made payable to "Collector of Internal Revenue at (City), (State)" and be made collectible at par without deduction for exchange.

RULING. A taxpayer who tenders a check whether certified or uncertified in payment for taxes is not released from his obligation until the check is paid. Where such a check is lost in the mails, a Collector of Internal Revenue is not required, as a condition precedent to the issuing of a duplicate check by a taxpayer, to furnish bond indemnifying him against possible loss in connection with the first check. (C. B. 3, page 371; O. D. 626.)

PAYMENTS IN TREASURY NOTES OR CERTIFICATES OF INDEBTEDNESS.—

LAW. Section 1325. That collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States . . . . in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp,[52] . . . .

This practice was begun in 1917.[53]

The purchase of certificates of indebtedness affords a convenient and economically sound method of providing in ad-

[51] Section 1325. See also Art. 1733.

[Former Procedure] The 1917 law (section 1010) was the first to authorize collectors to accept uncertified cheques in payment of taxes. (See T. D. 2627 and 2666.)

[52] With exception of the words "notes or" after the words "accrued interest," this section is the same as section 1314 of the 1918 law.

[53] Section 1010, 1917 law.

vance for taxes. They may be purchased at par, they bear interest at a fair rate and mature at various dates. Taxpayers can accumulate the certificates, as funds are available, at any time before the tax payments are due and on the due dates present them with the tax bills. In the meantime interest will have accrued.

The latest available instructions relative to the acceptance of certificates of indebtedness are as follows:

REGULATIONS. Collectors of internal revenue are authorized and directed to receive at par United States Treasury certificates of indebtedness of series TM-1922 dated March 15, 1921, series TM-2, 1922, dated August 1, 1921, and series TM-3, 1922, dated September 15, 1921, all maturing March 15, 1922, in payment of income and profits taxes payable on March 15, 1922; Treasury certificates of indebtedness of series TJ-1922, dated June 15, 1921, and series TJ-2, 1922, dated December 15, 1921, both maturing June 15, 1922, in payment of income and profits taxes due on June 15, 1922; series TS-1922, dated September 15, 1921, TS-2, 1922, dated November 1, 1921, both maturing on September 15, 1922, in payment of income and profits taxes payable on September 15, 1922; and TD-1922, dated December 15, 1921, maturing on December 15, 1922, in payment of income and profits taxes payable on December 15, 1922. Collectors are further authorized and directed to receive at par, in payment of income and profits taxes payable at the maturity of the certificates, respectively, Treasury certificates of indebtedness of any other series which may be issued maturing on March 15, June 15, September 15, or December 15, 1922. Collectors are not authorized hereunder to receive in payment of income or profits taxes any Treasury certificates of indebtedness not expressed to be acceptable in payment of income and profits taxes, nor any Treasury certificates maturing on a date other than the date on which the taxes are payable. Collectors are authorized to receive Treasury certificates of indebtedness which are acceptable as herein provided in payment of income and profits taxes in advance of the respective dates on which the certificates mature. Treasury certificates acceptable in payment of income and profits taxes have one or more interest coupons attached, including as to each series a coupon payable at the maturity of the certificates, but all interest coupons must in each case be detached by the taxpayer before presentation to the collector, and collected in ordinary course when due. The amount, at par, of the Treasury certificates of indebtedness presented by any taxpayer in payment of income and profits taxes must not exceed the amount of the taxes to be paid by him, and collectors shall in no case

pay interest on the certificates or accept them for an amount other or greater than their face value. (Art. 1731.)

. . . . Collectors of internal revenue are not authorized, unless express instructions otherwise are given by the Secretary of the Treasury, to receive in payment of income or profits taxes interim receipts issued by Federal reserve banks in lieu of definitive certificates of the series herein described. . . . .

For the purpose of saving taxpayers the expense of transmitting such certificates as are held in Federal reserve cities or Federal reserve branch-bank cities to the office of the collector in whose district the taxes are payable, taxpayers desiring to pay income and profits taxes by such Treasury certificates of indebtedness acceptable in payment of taxes, should communicate with the collector of the district in which the taxes are payable and request from him authority to deposit such certificates with the Federal reserve bank in the city in which the certificates are held. Collectors are authorized to permit deposits of Treasury certificates of indebtedness in any Federal reserve bank with the distinct understanding that the Federal reserve bank is to issue a certificate of deposit in the collector's name covering the amount of the certificates of indebtedness at par and to state on the face of the certificate of deposit that the amount represented thereby is in payment of income and profits taxes. The Federal reserve bank should forward the original certificate of deposit to the Treasurer of the United States, with its daily transcript, and transmit to the collector the duplicate and triplicate, accompanied by a statement giving the name of the taxpayer for whom the payment is made in order that the collector may make the necessary record and forward the duplicate to the office of the Commissioner of Internal Revenue. (Art. 1732.)

Victory notes in coupon form accepted for income and profits taxes payable March 15, 1922.—

Collectors of Internal Revenue are authorized and directed to receive at par Victory notes of either the 4¾ per cent or the 3¾ per cent series, in coupon form, in payment of income and profits taxes payable on March 15, 1922. Registered Victory notes are not acceptable. Coupon Victory notes tendered in payment of income and profits taxes payable March 15, 1922, must have all unmatured interest coupons attached (that is to say, coupons for June 15 and December 15, 1922, and May 20, 1923), but all matured coupons must be detached and collected in ordinary course when due. The amount, at par, of the Victory notes presented by any taxpayer in payment of income and profits taxes must not exceed the amount of the taxes to be paid by him, and collectors shall in no case pay interest on the notes or accept them for an amount other or greater than their face

value. Accrued interest on the notes accepted, from December 15, 1921, to March 15, 1922, will be remitted to the taxpayer by the Federal Reserve Bank with which the collector makes his deposits, on the basis of the schedules furnished by the collector. Receipts given by collectors to taxpayers should show the amount of notes of each series received in payment of taxes. . . . . (T. D. 3281, dated February 7, 1922.)

Commissioner may extend date of payment.—The new law permits the Commissioner, under certain conditions, to extend the date of payment of additional assessments.

LAW. Section 250. . . . . **(f) In the case of any deficiency (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of eighteen months from the passage of this Act as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted. There shall be added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1 per centum per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-thirds of 1 per centum per month. If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per centum of the deficiency and interest on the deficiency at the rate of 1 per centum per month from the time it becomes payable in accordance with the terms of such extension. . . . .**

Subdivision (h) of this section provides that the above shall also apply to any assessments which may be made under the 1917 and 1918 laws.

REGULATION. Section 250 (f) of the Revenue Act of 1921 contains a special relief provision which will be in effect for only eighteen months after November 23, 1921, the date of the passage of the Act. .It provides that in the case of any deficiency in tax revealed on the examination of an income or profits tax return (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to the satisfaction of the Commis-

sioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for a period not to extend beyond 18 months from November 23, 1921. Where such an extension is granted there is to be added as part of the deficiency in lieu of other interest provided by law, interest at the rate of two-thirds of 1 per cent per month from the time the extension is granted. Where such other interest provided by law, however, is in excess of two-thirds of 1 per cent per month the higher rate will be charged. If the deficiency or any part thereof is not paid in accordance with the terms of the extension agreement, there is to be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per cent of the deficiency together with interest on the deficiency at the rate of 1 per cent per month from the time it became payable under the terms of the extension agreement. The extension will be granted only in case the taxpayer establishes to the satisfaction of the Commissioner that without such extension undue hardship will result to the taxpayer. The term "undue hardship" means more than an inconvenience to the taxpayer. It is defined as meaning that substantial financial loss or sacrifice will result to the taxpayer from making payments of the deficiency at the due date. This provision of the statute is applicable only to deficiencies in taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918, or the Revenue Act of 1921, and the deficiency referred to is only such deficiency in tax as is revealed on the examination of an income or profits tax return. It has no application to deficiencies in taxes other than deficiencies in income and profits taxes under the three Acts named. No extension of time may be granted under subdivision (f) of section 250 for the payment of any regular installment of tax due as showing by the original return of the taxpayer.

Any application for the extension must be made under oath on Form 1127[54] in accordance with instructions printed thereon and must be accompanied by evidence showing that undue hardship to the taxpayer would result if the extension were refused. The extension will not be granted on a general statement of hardship, but in each case there must be furnished a statement of the specific facts showing what, if any, financial loss or sacrifice will result if the extension is not granted. Teh application should, whenever practicable, contain a certified statement of assets and liabilities of the taxpayer. The application, with the evidence, must be filed with the collector, who will at once transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner it will be examined and within thirty days either rejected or tentatively approved.

[54] See Appendix B.

Where the application is tentatively approved and a bond is required it must be filed with the collector within 10 days after the notification by the Commissioner that a bond is required. It shall be conditioned for the payment of the deficiency and applicable penalties, if any, and interest in accordance with the terms of the extension to be granted and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds and shall be subject to the approval of the Commissioner. In lieu of such a bond the taxpayer may file a bond secured by deposit of Liberty bonds or other bonds or notes of the United States equal in their total par value to the amount of the deficiency and applicable penalties, if any, and interest, as provided in section 1329 of the Revenue Act of 1921. (Art. 1014.)

If collectors insist on surety bonds in all cases, the "relief" will be barren because most taxpayers who cannot pay are also unable to comply with the requirements of surety companies. If taxpayers are able to furnish bond, that fact alone should make the filing of bonds unnecessary.

The United States has a first lien on the property of taxpayers and this is reasonable protection. It is not fair to creditors whose claims are subordinate, that surety bonds be demanded when taxpayers are unable to furnish them.

Receipts for taxes paid.—The law requires collectors to give receipts only when requested to do so by taxpayers.

LAW. Section 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

RULING. . . . . Receipts are documents required by provisions of the internal revenue laws and by regulations made in pursuance thereof, within the meaning of section 3451, Rev. Stat., making it an offense to simulate or falsely or fraudulently execute or sign any document required by the internal revenue laws, or any regulation made in pursuance thereof, or to procure the same to be falsely or fraudulently executed, or to advise, aid in, or connive at such execution thereof. . . . .

The offense may be committed either where the receipt itself is a genuine receipt of the kind kept for that purpose in the office of the internal revenue collector but signed by the defendant without authority, or where, even if not a blank of the kind required to be kept, the blank itself is simulated or falsely or fraudulently executed and issued by a person who has no power or authority to do so. . . . . (T. D. 2874, June 23, 1919.)

The author is informed that some taxpayers have not received receipts although specific requests were made for them, and that such failure has caused great inconvenience when taxpayers have gone abroad. Moreover, inconvenience is often caused by the lack of receipts when taxpayers file claims for refund. If receipts are not available to accompany claims, photostated copies of paid cheques should be used.

Collection of Taxes by Suit and Summary Process

In view of the possibility that during the coming year certain taxpayers may be unable to pay the tax assessed upon them, it may be of interest to include the articles of the regulations dealing with collection by suit and by summary process peculiar to United States practice.

Collection by suit.—Obviously the government will not resort to an action at law if taxes can be collected by summary assessment followed by distraint on the property of the taxpayer. In the latter case the government "gets the money," in the former case a long period of time elapses before the action can be tried and in very many cases the government fails in its action. Therefore taxpayers who have meritorious cases cannot be criticized for not signing waivers in order to

enable the government to force the collection of taxes illegally assessed.

If the taxpayer agrees that the additional tax is due, the waivers should be signed, but not otherwise.[55] Specific and not blanket waivers should be signed.

Under the 1917 and prior laws there was no limitation on the time within which the government could bring suit. The 1918 law provided that, except in the case of fraud, suit had to be brought within five years from the time when the return was due. The 1921 law has made some radical changes with reference to limitation. There is now a limitation period both as to suits and assessments[56] for all laws.

Suits for taxes barred after five years.—

LAW. Section 1320. That no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five years from the time such tax was due, except in the case of fraud with intent to evade tax, or willful attempt in any manner to defeat or evade tax. This section shall not apply to suits or proceedings for the collection of taxes under section 250 of this Act, nor to suits or proceedings begun at the time of the passage of this Act.

The foregoing section applies to all internal revenue taxes. While included in the 1921 law, it also covers all prior laws.

Collection of tax by distraint.—The Revised Statutes[57] authorize collectors to collect taxes by distraint and sale. The following regulation summarizes sections 3187 and 3196 of the Revised Statutes:

REGULATION. If any person liable to pay any taxes neglects or refuses to pay them within ten days after notice and demand, it shall be lawful for the collector or his deputy to collect such taxes with 5 per cent additional and interest at 12 per cent per annum by distraint and sale of the goods, chattels or effects, including stocks, securities, and evidences of debt, or other property or rights of property, of the person delinquent. When goods, chattels, or effects sufficient to satisfy the taxes and penalties imposed upon any person are not found by

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[55] For discussion of legality of waivers, see footnote 20, page 199.
[56] See page 195.
[57] Sections 3187 to 3196, inclusive.

the collector or deputy collector, he is authorized to collect such taxes by seizure and sale of real estate. . . . . (Art. 1009.)

RULINGS. The property of one spouse is not subject to distraint to enforce payment of an income tax obligation of the other spouse unless there has been a transfer of property from one spouse to the other after a tax has been assessed and demand made for payment thereof. (B. 40-21-1856; O. D. 1056.)

Property possessed by a taxpayer at the time a lien for tax attached under section 3186, R. S., is subject to distraint for the collection of the tax and interest in the hands of a person who acquired it by reason of his death. (B. 51-21-1986; O. D. 1144.)

Enforcement of tax lien by bill in equity.—The government may secure a lien for unpaid taxes. The following regulation outlines the procedure which must be followed under section 3186 of the Revised Statutes:

REGULATION. In the event of nonpayment of a tax and penalties after demand, the amount becomes a lien in favor of the United States from the time when the assessment list was received by the collector upon all property and rights to property belonging to the taxpayer, except that the lien is not valid as against any bona fide mortgagee, purchaser, or judgment creditor until notice thereof is filed in the proper public office or offices on Form 668. The collector may file such notice of lien upon making demand for payment of the tax, unless payment is made immediately upon demand. What is immediate payment will depend upon the nature of the demand. Where the collector contemplates filing such notice of lien on demand, whenever practicable, the demand should be made upon the taxpayer in person. In any case where there has been refusal or neglect to pay the tax and it has become necessary to seize and sell real estate to satisfy it, a bill in equity may be filed in a district court of the United States to enforce the lien of the United States for tax upon any real estate in which the delinquent has any right, title, or interest subject to the lien. This remedy does not supersede distraint but is cumulative. (Art. 1010.)

The district courts of the United States are invested with jurisdiction to render such judgments and decrees, both in law and in equity, as may be necessary or appropriate for the enforcement of the provisions of the law.[58]

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[58] Section 1318.

Compromise of taxes and penalties.—Section 3229 of the Revised Statutes gives the Commissioner power to compromise cases of taxes and penalties both before and after suit has been commenced. The nature and extent of this power are explained in the following regulation.

Regulation. The Commissioner, with the advice and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon, and with the advice and consent of the Secretary and the recommendation of the Attorney General may compromise any such case after suit thereon has been commenced by the United States. Accordingly, the power to compromise extends to (*a*) civil and criminal cases; (*b*) cases whether before or after suit; and (*c*) taxes and penalties, except that taxes legally due from a solvent taxpayer may not be compromised. Refunds can not be made of accepted offers in compromise in cases where it is subsequently ascertained that no violation of law was involved. . . . . (Art. 1011.)

A letter, similar in content to the following, suitably modified if the delinquent was a corporation, has been used in the past by the collectors in charging taxpayers with delinquency and in notifying them of their privilege to submit offers in compromise.

Sir: Your return of net income was not received in this office until ......, thereby involving you in liability to a specific penalty of not less than $20.00, or more than $1,000, under the act of ......, in addition to the 50 per cent additional tax which will be assessed and collected.

The provisions of the act are mandatory, and no excuse or explanation can be accepted, except a showing that a complete or tentative return was in fact mailed in time to have reached this office, or a Deputy Collector, in the ordinary course of business on or before March 1, ...

However, before instituting proceedings in court for the imposition of the specific penalty, I am directed to call your attention to the provisions of section 3229, revised statutes, which reads in part as follows:

> "The Commissioner of Internal Revenue with the advice and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon, ..."

Should you desire to take advantage of your privilege under this

section and to submit an offer in compromise, the amount offered should be forwarded promptly *to this office* in the form of cash, postal money order, or certified check which can be cashed without cost, payable to my order, accompanied by an affidavit substantially in the following form:

> "To the Commissioner of Internal Revenue:
>
> "I hereby solemnly swear (or affirm) that my delinquency in filing return of net income as required by the act of ...... was not due to any intent to violate the law or evade taxation, but was due to (here insert, concisely and clearly, the reason for delay).
>
> "Desiring to compromise my liability I hereby tender the sum of $......, which I request be accepted in compromise of the specific penalty only."

To be signed and sworn to before a deputy collector, notary, or other officer authorized to administer oaths.

This affidavit will then be forwarded by me, together with the sum offered, to the Commissioner for consideration, and you will be notified by him of his acceptance or rejection of your proposal. In the latter event, you may increase your offer, if you so desire.

In an opinion dated June 3, 1919,[59] the United States Attorney General held that claims falling in the following classes may be compromised by the Commissioner whenever, in his judgment, such compromises are for the interest of the United States:

> Claims for sums of 5 per cent on amounts of income and excess-profit taxes not paid when due and interest at the rate of 1 per cent per month on said taxes, the collection of which is authorized by sections 9(a) and 14(a) of the act of September 8, 1916, and section 212 of the act of October 3, 1917.

The Treasury has also held in a law opinion[60] that an ad valorem fraud penalty "may at any stage be compromised by the Commissioner and the approving officials, whether or not it be formally assessed."

[59] 31 Op. Att. Gen. 459.
[60] Bulletin 41-21-1864; L. O. 1072.

CHAPTER IX

APPEALS, REFUNDS AND ABATEMENTS OF OVER-ASSESSMENTS

The preceding chapter deals with the administrative procedure in connection with assessments and payments of taxes. This chapter deals with the remedial procedure provided by the Treasury or the courts whereby the taxpayer may abate the assessment and either secure a cancellation of the assessment or obtain a refund of taxes overpaid.

Prior to the passage of the 1921 law, the Treasury acted on the theory that additional assessments should be made as soon as possible, usually upon the recommendation of the audit section,[1] in order that interest would commence to accrue to the government.

The present law should bring about a reversal in the policy of the Treasury. Additional assessments for the taxable year 1921 and subsequent years will bear interest at the rate of 6 per cent per annum from the time the tax was originally due.[2]

Proposed additional assessments should be carefully considered before demand for payment is made. The new law also provides that interest shall be paid on taxes illegally collected and later refunded.[3]

The policy of the Treasury prior to 1922 in making assessments of additional taxes before final decisions, had the inevitable result—the majority of taxpayers filed claims in abatement instead of paying the assessments. The Treasury recognized that the claim in abatement evil had grown to serious proportions.

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[1] See *Income Tax Procedure,* 1921, page 171.
[2] Section 250 (b).
[3] Section 1324.

The great defect has been that taxpayers inevitably gained the impression that conferees had little discretion and that the assessment would be made as a matter of course. A sharp distinction should be drawn between the work of an auditor, whether done in the field or in the office, and the work of the conferees. The auditors, in effect, must attempt to assess the maximum amount of tax which under any interpretation of the regulations can be assessed. The conferees, however, should act as disinterested judges.[4]

The hearings before the conferees should be as impartial as those before the Committee.

Subdivision (d) of section 250 permits an appeal to the highest body in the Treasury before assessment. This subdivision provides that after a taxpayer has been notified of a proposed additional assessment, he shall be given "a period of not less than thirty days . . . . in which to file an appeal." This subdivision further provides that, "Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable."

These two changes should result in more deliberate action by the Treasury in the assessing of additional taxes.[5]

Importance of filing claims.—The preceding chapter fully covers appeals from the findings of revenue agents, and in general all remedial measures up to the time of assessment. After an assessment has once been entered on the collectors' lists, there is no recourse except by a claim for abatement (before the tax is paid)[6] or refund (after the tax is paid).

Many of the additional assessments following examinations of taxpayers' returns are based upon erroneous conclusions drawn by examiners, which the courts would promptly reverse if the taxpayers brought suit. But suits at law are so expensive, or are thought to be, and delays and postponements

[4] For discussion of procedure of Income Tax Unit, see page 174.

[5] See page 241.

[6] Claims for abatement may now be filed in only a few instances. See page 242.

are so frequent and annoying, that most of those reassessed pay even when they are sure of the injustice of the tax.

Because of the many erroneous assessments which have been made, taxpayers should be informed as to the details of steps to be taken to question an assessment. If a claim is refused, the necessary procedure to secure from the courts an impartial opinion as to the sufficiency of the taxpayer's side of the contention should be understood. Until the case reaches the courts it cannot always be said that the facts are passed upon impartially.[7]

Many of the inequalities which existed under past practice were due to the thought on the part of those administering the law that there was no middle ground. Any doubtful point, no matter how great an injustice it might work, was decided against the taxpayer. During recent years the Treasury has, however, shown some improvement in this respect.

It is probable that many court decisions will be required before the rights of taxpayers are fully protected. In the meantime, all legal formalities should be observed by taxpayers so that they may secure the benefit of any future decisions which reverse past rulings of the Treasury.

Taxpayer's right to question assessment.—Vast numbers of persons pay too much tax for a variety of reasons: ignorance; the desire to overpay rather than to underpay; the tendency to follow Treasury rulings even though obviously illegal; fear of penalties; fear that failure to pay will be called unpatriotic; and many others. In view of the fact that in a democracy the people are supposed to be sovereign and public officers their servants, this tendency is hard to understand. It probably results from the disinclination of the average well-to-do American to go to any trouble about overcharges of any kind. He will pay a cab driver an extortionate fare rather than question the rate. He will tip an insolent and

[7] For appeals to the Committee of Appeals and Review, see page 175 *et seq.*

inefficient waiter rather than be looked at unkindly or spoken to offensively.

It is so with taxes. But there should be a change. Public officers, at least those in Washington, are not to blame. An effort has been made to render the remedy of an aggrieved taxpayer as inexpensive and as little troublesome as possible. Taxpayers who refuse to acquaint themselves with the remedies and means for correcting erroneous assessments have only themselves to blame.

Right to question Treasury rulings.—Regarding the taxpayer's right to question rulings and assessments, the following authoritative quotation is pertinent:

And it follows that it will be a legitimate mode of construing the present income tax law, in cases where its language in relation to a particular point or subject is obscure, confusing, or unintelligible, to compare it with the corresponding provisions on the same point in the earlier acts, which may be more clear and precise, and to presume that Congress intended its words to be understood in the same sense as before, unless there is such a distinct change of language as to compel the inference that a change in legislation was certainly intended.[8]

Also the following quotations from decisions of the United States Supreme Court are of interest. The first quotation is taken from *Gould v. Gould.*[9]

Decisions. In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen. *United States* v. *Wigglesworth*, 2 Story 369, Fed. Cas. No. 16,690; *American Net and Twine Co.* v. *Worthington*, 141 U. S. 468, 474, 35 L. Ed. 821, 824, 12 Sup. Ct. Rep. 55; *Benzinger* v. *United States*, 192 U. S. 38, 55, 48 L. Ed. 331, 338, 24 Sup. Ct. Rep. 189.

Keeping in mind the well-settled rule, that the citizen is exempt from taxation, unless the same is imposed by clear and unequivocal language, and that where the construction of a tax law is doubtful,

[8] Black, *Income and Other Federal Taxes,* 4th edition, page 36.
[9] 245 U. S. 151; 38 S. Ct. 53; 62 L. Ed. 211.

the doubt is to be resolved in favor of those upon whom the tax is sought to be laid.[10] . . . .

Taxpayers should inform themselves as to the attitude of the courts on doubtful points which arise in the course of the administration of the law as indicated by the foregoing quotations and by the following clear-cut statement in a recent case.

Decision. Where there is an ambiguity in the language of a statute imposing a tax, and that ambiguity raises a doubt as to the legislative intent, the persons upon whom it is sought to impose the burden are to be given the benefit of the doubt.[11]

In an earlier case this is found:

Decision. At the outset it may be remarked that a statute providing for the imposition of taxes is to be strictly construed, and all reasonable doubts in respect thereto resolved against the government and in favor of the citizen.[12]

The question of the authority of Treasury regulations is most aptly discussed in Black's *Income Taxes* (4th edition), page 9.

But of course it is not within the lawful power of these officers to go a step beyond the limits of the act of Congress under which their authority is exercised. They could neither bring within the purview of the law or of their regulations anything not definitely within the words of the act, nor except from its operation anything not clearly meant to be excluded, nor add to the burden of the taxpayer anything which Congress did not intend to impose upon him. But within the limits of their rightful authority, regulations prescribed by the Commissioner of Internal Revenue, pursuant to statutory authority, with the approval of the Secretary of the Treasury where necessary, in respect to the assessment and collection of internal revenue taxes, or for the government of the officers of the revenue department, have all the force and effect of law, and are as binding as if incorporated in the statute law of the United States; and the acts of the Commissioner are presumed to be the acts of the Secretary. But the construction given to an act of Congress imposing internal revenue taxes by the Commissioner of Internal Revenue, though officially published, is not a construction of so much dignity

[10] *Spreckles Sugar Co. v. McClain,* 192 U. S. 397; 24 S. Ct. 376; 48 L. Ed. 496.

[11] *Edwards v. Wabash Railway Co.,* 264 Fed. 610, 619.

[12] *Mutual Benefit Life Ins. Co. v. Herold,* 198 Fed. 199; affirmed 201 Fed. 918; 120 C. C. A. 256.

that a re-enactment of the statute subsequent to the construction is to be regarded as a legislative adoption of that construction, and especially when the construction would make a proviso to the act repugnant to the body of the act.

In *Thacher v. United States,*[13] the court said:

Decision. The Commissioner of Internal Revenue cannot alone, or in connection with the Secretary of the Treasury, alter or amend the internal revenue law. All he can do is to carry into effect that which Congress has enacted. His regulations in aid of the execution of the law must be reasonable, and made with a view to the due assessment and collection of the revenue.

Changed interpretation—retroactive effect.—It should be borne in mind that Treasury interpretations are, after all, merely interpretations. Therefore, if the courts decide that the law means something different from what the Treasury has held it to mean, the rulings must be reversed and redress granted or additional levies made back to the date of the passage of the law.

The new law provides:

Law. Section 1314. **That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.**

It is not easy to make a general statement as to how far a Treasury ruling which reverses some previous Treasury ruling is retroactive. Much depends upon the circumstances. Certainly administrative difficulties are sufficient to justify the prohibition of wholesale readjustments of returns unless the changes are of considerable importance. In the language of the regulations, "cases previously adjusted in contravention of law, as pronounced in such decisions, are subject to readjustment in accordance with the decisions."

[13] 15 Blatch 15, Fed. Cas. No. 13851.

Abatement

When notice of assessment of additional tax was received prior to the 1921 law, it was difficult to decide whether to file claim for abatement and at least defer payment of the tax, or to pay the tax and file claim for refund.

Under the new law a claim for abatement may be filed only in a few instances.

LAW. Section 250. . . . . . (d) . . . . If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918 or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: *Provided,* That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing. . . . .

There can be no doubt as to the meaning of the foregoing section. Except in those cases where the Commissioner may believe the additional tax is in jeopardy, an application in the nature of a formal appeal must be allowed. Whether the appeal is heard by the Commissioner himself through the Committee on Appeals and Review, or before some other appeal body of unquestioned standing, is immaterial. The reference of an appeal to a subordinate section or to anyone who had theretofore passed upon the case will not be an appeal within the meaning of the law.

Decision must be made before assessment, provided, of course, notice of appeal is filed in accordance with the statutory provision.

If notice of appeal is not given within the specified time,

the assessment must be paid in due course. The collector is not authorized to accept a claim for abatement. In such a case a claim for refund is the only recourse.

Abatements may be filed—when?—Claims for abatement have not, however, been entirely abolished. Use for such claims may be found in the following cases:

1. Where the Commissioner believes the tax is in jeopardy.
2. Where it is necessary to postpone payment of one or several instalments. Cases of this kind may occur where an error has been discovered before all instalments of a tax have been paid.
3. Where a claim for abatement or credit on file with the Treasury has been disallowed without the taxpayer having had an opportunity to be heard on appeal. Cases of this kind can be eliminated by changing the procedure with regard to claims of all kinds. This change is discussed elsewhere.[14]
4. Where an erroneous assessment is made. It is predicted that assessments will be made where the taxpayer has not been notified in accordance with the law. Also, taxpayers will often file a notice of appeal and yet the assessment will be made. It is natural for mistakes of this sort to happen, especially in government offices.

Experience will no doubt show that other cases will arise, because a claim for abatement may be used where there is any good reason to hold a payment in abeyance; provided, however, that the case is of a kind in which the law does not specifically forbid the acceptance thereof.

Interest payable on abatement—when?—When claim for abatement is filed there is in any case some chance that the claim of the taxpayer will be denied. Therefore it is important

[14] See page 213.

that the claim for abatement be filed within ten days from date of assessment in order to prevent the 5 per cent penalty from being imposed.

LAW. Section 250. . . . . (e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided,* That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected. . . . .

If the claim or any part of it is denied, interest at the rate of 6 per cent per annum[15] will be added to the amount disallowed. Where, however, a claim for an abatement is filed under the 1918 act, based on the grounds of a loss in inventory,[16] interest at the rate of 12 per cent per annum will be added to the tax not abated, beginning with the original due date.[17]

Section 250 (e) applies to claims for abatement under both the 1918 and 1921 laws.

The 1921 law does not make any important change in this section.

Under laws previous to that of 1918, interest at the rate of 1 per cent a month is imposed upon the amount disallowed.[18] The author is of the opinion that this interest may in certain cases be reduced to 6 per cent by paying any additional assessment for the year 1917 and filing a claim for credit against any instalments which will fall due within that year. The taxes

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[15] If it is held that the claim is not made in good faith the rate of interest is 12 per cent.

[16] *Income Tax Procedure,* 1921, page 188.

[17] Section 214 (a-12), 1918 law.

[18] C. B. 4, page 318; O. D. 798.

against which the credit would be claimed would of course be a year subsequent to 1917. Under the 1918 and 1921 laws a claim for credit bears interest at 6 per cent per annum. The 1917 payment should of course be made under protest and it would also be well at that time to advise the collector of the taxpayer's intentions.

RULING. Advice is requested whether it is permissible for an individual to file a claim for abatement of tax and penalties assessed after service of second notice and demand on Form 21 and issuance of warrant of distraint on Form 69.

Held, that a bona fide claim for abatement may be filed at any time prior to payment of the tax. The filing of a claim for abatement, however, does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. He should, if he considers it necessary, collect the tax and leave the taxpayer to his remedy by claim for refund.

If a claim for abatement of a tax is filed after the taxpayer has incurred the 5 per cent penalty and 1 per cent a month interest for nonpayment within the prescribed time, the penalty and interest should not be collected unless the claim is decided adversely to the taxpayer.

In the case of an adverse decision, the amount disallowed in claim for abatement, plus interest thereon, at the rate of 1 per cent a month from the original due date of the tax until the date of filing abatement claim, and at the rate of one-half of 1 per cent per month from the latter date until the date of the adverse decision, together with the 5 per cent penalty on the amount of tax disallowed, should be collected from the taxpayer. (B. 51-21-1985; O. D. 1143.)

May abatement be allowed if an equivalent amount of tax is due?—Since very few abatement claims will be filed under the 1921 law, the following ruling applies principally to cases arising under the 1918 and prior laws:

RULING. The validity of an assessment depends upon the law and actual facts existing. Therefore, an assessment made upon an erroneous theory or by mistake may not be remitted or abated because so made if, at the time its validity is passed upon the Commissioner is in possession of evidence which shows an equivalent amount of tax is properly due in connection with the income, transaction or matter upon which the assessment is predicated. (B. 49-21-1967; T. D. 3251.)

The validity of the foregoing ruling is questioned. Under the laws prior to 1921, interest did not begin to run until after assessment was made. This ruling may subject taxpayers to interest charges from the dates of the illegal assessment, without proper compliance by the Treasury with the sections of the law dealing with other assessments (even though meritorious) barred by limitation of time, as well as where interest is specifically held to commence when collectors give notice of assessments.

Content of claim in abatement must be supported by sworn statement.—The following regulation sets forth the details of procedure in claims for abatements:

REGULATION. Claims for abatement of taxes illegally or erroneously assessed shall be made on Form 843. They must be sustained by the affidavits of the parties against whom the taxes were assessed, or of other parties cognizant of the facts. When a tax has been assessed and turned over to the collector, the presumption is that the assessment is correct. The burden of proof in rebutting the presumption and showing that it was improperly or illegally assessed, or that relief should be given under a remedial statute, rests upon the applicant for abatement. The affidavits must therefore contain full and explicit statements of all the material facts relating to the claim in support of which they are offered and to the proper consideration of which they are essential. The legality of the claim is to be determined by the Commissioner upon the facts presented to him. The filing of a claim for abatement does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. He should, if he considers it necessary, collect the tax and leave the taxpayer to his remedy by a claim for refund. Claims for abatement may not be filed where the taxpayer has had the benefit of the provisions of section 250(d).[19] . . . . (Art. 1032.)

Provision has been made in this article for appeal under section 250 (d); otherwise there is no change.

The author's experience has been that many claims for abatement are denied because the foregoing reasonable and

[19] Section 250 (d) gives the taxpayer the right, upon notice of assessment to be made in thirty days, to appeal before such assessment is finally made.

legal procedure is not followed by taxpayers. It is not enough to make a short affidavit to the effect that the tax is illegally or wrongfully assessed. It should be remembered that the additional assessment is often the result of a long and careful audit of the returns. The taxpayer is entitled to and should have full particulars of the basis of the assessment.

The claim for abatement should contain complete references to the law and regulations bearing on the matters in dispute and should cite such authorities, precedents and business practices as are applicable. The author has never known of a case where the presentation of a carefully prepared claim has not received equally careful attention.

Meaning of term "bona fide claim."—Section 250 (e) of the law provides that, when the claim for abatement is made in good faith and subsequently denied, interest at the rate of ½ of 1 per centum per month shall be charged on the tax from the time it was due until the claim is decided. It is therefore of great importance not to invoke the law unless the abatement can be proved to be "the subject of a bona fide claim." It has been shown that taxpayers have an undoubted right to question assessments, but the questioning of an assessment must be founded on more than mere doubt in order to support a contention that a claim for abatement is filed in good faith.

When the taxpayer is confident that his original return was properly prepared there can be little doubt as to the imposition of the 6 per cent interest rate if the claim for abatement is denied. The Commissioner, in order to impose the 12 per cent interest rate, would have to hold that the claim was made in bad faith. Taxpayers should be able to make a good showing in the hearing of their cases and leave no doubt in the minds of the reviewing authorities as to the good faith involved in the claim.

Collector may require a bond.—As it is within the discretion of a collector to accept or reject a claim for abatement

and, as he is charged personally with the assessment, he may require a bond at the time of accepting a claim for abatement.

RULING. . . . . While there is no provision of law expressly authorizing the collector to require a bond as a condition of suspending the collection of the tax, he is personally charged with the amount of the assessments made against taxpayers in his district and he is required to use due diligence in collecting such taxes. If he fails to exercise due diligence, it is clear that he becomes personally liable for any tax which may be lost through such failure. He may require the tax to be paid and leave the taxpayer to his remedy by a claim for refund, and if he see fit to suspend the collection of the tax in any case where a final collection may thus be jeopardized he does it at his own risk. It is within his discretion to protect himself by requiring the taxpayer to execute a bond in the amount of the tax the collection of which is postponed. . . . . (C. B. 1, page 257; O. 957.)

Section 1329 provides that the collector may accept as security Liberty bonds or other bonds or notes of the United States.

When may a collector reject a claim for abatement?—The question has arisen as to whether or not a collector, after he has accepted a claim for abatement and has forwarded it to the Commissioner, may send out a second notice and demand, although the Commissioner has neither allowed nor rejected the claim, requiring payment within 10 days. These second notices and demands not only include the original amount of the assessment but add the 5 per cent penalty and interest at the rate of 1 per cent a month. If the tax is not paid or if a bond is not filed, may the collector proceed to collect by distraint?

Since a large number of collectors passed out of office with the change in administration, the above procedure was followed to establish the requirement of due diligence in endeavoring to collect the tax.

After a collector accepts a claim for abatement and forwards it to the Commissioner for consideration, the collector should not send out a second notice and demand until the Commissioner has notified him that it has been rejected. If, how-

ever, the second notice is sent, the collector should be informed that a claim in abatement is already on file. Form 843 can be used for this purpose, a copy of the former claim being attached. By this means, it is possible that summary action by the collector may be prevented.

At the time when the claim is accepted the collector must be convinced that it is a "bona fide claim," and that the taxpayer is in a position to pay and will pay the tax if the Commissioner, after consideration, rejects it. Of course, if after a claim has been accepted some unforeseen event takes place which may jeopardize the government's interest, it would be reasonable to demand either a bond or payment. But this certainly should be done only with the approval of the Commissioner, because there are many taxpayers who have claims pending with the Treasury which have been on file many months.

In any event, it is improper to include the 5 per cent penalty and interest at the rate of 1 per cent a month, because the penalty has been made inoperative by the filing of the claim for abatement, and interest can only be collected on the amount of the claim disallowed by the Commissioner.

Claim for abatement filed by receivers.—

RULING. Where the property of a corporation is in the hands of a receiver who files a claim for abatement of an additional assessment of income and profits taxes for 1917, no bond should be required as security for the payment of such taxes. The government, however, has the right under section 3466, R. S., to receive payment of these taxes from the receiver in preference to the creditors of the corporation. (B. 47-20-1316; O. D. 733.)

Method of calculation of interest under 1918 law when a claim for abatement or credit is rejected.—

RULING. Where a claim for abatement (section 250 (e)) or a claim for credit (section 252) is rejected, the tax which is the subject of the claim is chargeable with interest at the rate of one-half of 1 per centum per month from the time the tax was originally due until the claim is decided adversely to the taxpayer; notice of the adverse decision is sent to the collector who must send to the claim-

ant a notice and demand for payment of the assessment; if the tax is paid within the ten day period following the sending of the notice the 5 per cent penalty is not collectible, and the only interest collectible is that at the rate of one-half of 1 per centum per month from the time the tax was originally due until the date of the Commissioner's decision; if the tax covered by the rejected portion of the abatement claim is not paid within ten days from the date of the notice and demand for payment, the penalty of 5 per cent attaches, and in addition thereto, interest at the rate of one-half of 1 per centum per month from the original due date to the date of the adverse decision by the Commissioner and at the rate of 1 per centum per month from that date to the date of payment. (B. Digest 31-20-1106; S. O. 32.)

If some time has elapsed, as is usually the case, between the date of the Commissioner's adverse decision and the placing of the assessment on the list, and if the taxpayer pays the tax within 10 days after notice and demand from the collector, he is charged interest only up to the date of the adverse decision, which may be a considerable time before the taxpayer actually pays the tax without penalty.

In the detailed opinion of the solicitor, it is stated:

. . . . the date of the adverse decision by the Commissioner becomes a newly established due date and is subject to all the provisions of law relating to penalties and interest.

Failure to pay within 10 days involves additional interest at 1 per cent a month from the date of the adverse decision to date of payment.

Actions to Restrain Payment of Taxes

If no claim for abatement is made, or if one is not permitted because a final decision has been made, or if claim is made and denied, the tax imposed must ordinarily be paid.

Suits to restrain collection of taxes—not maintainable.—

LAW. Section 3224. [Rev. Stat.] [Barnes' Federal Code, Section 5123.] No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.

The federal courts in construing this provision have uniformly held that no injunction will issue for this purpose.

It is of interest to note, in the case of *Snyder v. Marks,*[20] that, although it was alleged that the "assessment was made more than fifteen months after the time which it embraced had elapsed," a bill in equity will not lie to enjoin a collector of internal revenue from collecting the tax. The following language of the court is of particular importance because it relates to section 3224, which is still in effect:

> DECISION. The inhibition of section 3224 applies to all assessments of taxes, made under color of their offices, by internal revenue officers charged with general jurisdiction of the subject of assessing taxes against tobacco manufacturers. The remedy of a suit to recover back the tax after it is paid, is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive, and no other remedy can be substituted for it. Such has been the current of decisions in the circuit courts of the United States, and we are satisfied it is a correct view of the law.

It would appear that if Congress says in one section of the law that *no assessment* shall be made after the expiration of a certain period, and says in another that *no suit* shall be brought against the government to restrain the payment of taxes, the two sections should be construed together. If an injunction cannot be secured in case the assessment is made after the limitation period, the intention of Congress cannot be carried out. Otherwise the section in regard to the 3 or 5 years' limitation might as well have been omitted. Certainly, the enactments of Congress should have some effect.

A more recent case, *Markle v. Kirkendall,*[21] confirms the principle of the Snyder case. In the Markle case an attempt was made to restrain the collector from collecting a tax which the Commissioner had assessed against a taxpayer as a corporation, whereas the taxpayer was a copartnership when the tax was assessed. The court held that as long as the taxpayer can be brought within the terms of the law as taxable, the col-

[20] 109 U. S. 189; 27 L. Ed. 901; 3 S. Ct. 157; decided November 12, 1883.
[21] 267 Fed. 498.

lector may not be enjoined, although his proceeding is erroneous or irregular. The tax must be paid and if an appeal for refund is disallowed a suit may then be brought against the collector for recovery of the tax paid.

In the case of *Dodge Bros. v. Osborn,*[22] Chief Justice White intimated that an injunction might be secured in exceptional cases.

DECISION. . . . . the statute plainly forbids the enjoining of a tax unless by some extraordinary and entirely exceptional circumstance its provisions are not applicable.

The cases which hold that a stockholder may restrain collection in case of an *unconstitutional tax* were decided subsequent to 1888, the date of the Snyder case.

It may very well be, therefore, in case it can be shown that a suit against a collector to recover the tax paid and interest would not afford the taxpayer an adequate remedy, because, in order to pay the tax he would be compelled to dispose of property at a figure below its real worth, for which, of course, the return of the tax and interest, would not reimburse him, that a court of equity, in the exercise of its inherent jurisdiction to afford relief where a suitor has no adequate remedy at law, would act by injunction to prevent the collection of a tax illegally assessed. Such an injunction has recently been applied for in Delaware. Article 1050 states that the "restraining" provision does not apply to suits for injunctive relief.

Stockholders' suits.—In cases where a speedy determination of the constitutionality of the tax is desirable, a procedure has been followed which appears to be a justifiable evasion of the statutory inhibition against litigating the validity of taxes before their payment. This is done under the color of a stockholder's suit, brought to restrain the corporation from an alleged illegal use of the corporate assets. The right of a stockholder to maintain such a suit is now well estab-

[22] 240 U. S. 118; 36 S. Ct. 275; 60 L. Ed. 557.

lished.[23] The application of this procedure to tax cases was first resorted to in the *Income Tax Cases,*[24] and has been subsequently upheld as proper in view of the confusion and injustice which would result if the corporation paid the tax.[25]

Refunds

After a tax has been paid and a taxpayer believes that it was unlawfully or wrongfully assessed or collected he may make claim for refund (on form 843). Generally speaking, the government imposes no restrictions against claims for refund and such claims are considered on their merits. This practice must not be confused with the procedure in case of *suit* against the government. When suit is brought the government interposes all the legal obstacles at its command.

Refund of taxes erroneously collected.—The following regulation gives the details of procedure in claims for refund.

REGULATION. Claims by the taxpayer for the refunding of taxes and penalties erroneously or illegally collected shall be made on form 843. In this case the burden of proof rests upon the claimant. All the facts relied upon in support of the claim should be clearly set forth under oath. In the case of the taxpayer's death, certified copies of the letters of administration or letters testamentary, or other similar evidence, must be annexed to the claim to show the authority of the administrator or executor. The affidavit may be made by an agent of the person assessed, but in such a case a power of attorney must accompany the claim. Checks in payment of claims allowed will be drawn in the names of the persons entitled to the money and shall, unless otherwise directed, be sent directly to the proper persons. The Commissioner has no authority to refund on equitable grounds penalties legally collected.[26] . . . . (Art. 1036.)

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[23] *Dodge v. Woolsey,* 18 How. 331; 59 U. S. 331; 1 Miller 284; 15 L. Ed. 401; *Hawes v. Oakland,* 104 U. S. 450; 14 Otto 450; 26 L. Ed. 827. (See equity rule 94.)

[24] *Pollock v. Farmers' Loan & Trust Co.,* 157 U. S. 429; 39 L. Ed. 759.

[25] *Brushaber v. Union Pacific Ry. Co.,* 240 U. S. 1; 36 S. Ct. 233; 60 L. Ed. 493; *Stanton v. Baltic Mining Co.,* 240 U. S. 103; 36 S. Ct. 278; 60 L. Ed. 546.

[26] For cases in which refund is made through collectors, see *Income Tax Procedure,* 1920, page 217.

It should be noted that the new regulations do not require that claims for refund must be accompanied by the collector's receipt or by the paid cheque showing payment of the tax.

If claim for abatement was not made the claim for refund should be supported by satisfactory evidence as described on page 245. If claim for abatement was made and denied it cannot be expected that the claim for refund will be allowed, but the taxpayer has nothing to lose by attempting to improve his case and by securing any new evidence which will strengthen it.

Claims for refund may not be filed with Commissioner direct.—Prior to the issuance of the following ruling, refunds could be filed with the Commissioner direct.[27]

RULING. Claims for refund should in all cases be filed with the collector of internal revenue to whom the tax was paid or with the deputy collector of the division of such district in which the claimant resides. Warrants in payment of such claims will be made to the order of the claimants as provided in section 6, Department Circular 230 (not published in the Bulletin Service).

The Bureau will recognize a general power of attorney as sufficient authority for the filing of more than one claim for refund on behalf of the grantor of such power. It should be noted, however, that under the provisions of section 6 of the above-mentioned circular special powers are required in certain cases. In cases where a number of claims are to be filed under a general power of attorney the original power should be attached to the first claim filed on behalf of the claimant granting the power, and a copy thereof should be annexed to each succeeding claim, special reference being made in each copy to the claims to which the original instrument was attached.

The Bureau does not require that a power of attorney to file a claim for refund be in any special form. It is merely necessary that the instrument meet the legal requirements of powers of attorney in general.

A power of attorney given by a corporation should be signed by the officers who are duly authorized to execute such instrument. (C. B. 4, page 341; O. D. 867.)

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[27] See Letter dated March 29, 1919, *Income Tax Procedure*, 1921, page 212.

Formal claims for refund may not be necessary in some cases.—The Commissioner may now issue warrants to cover overpayment without requiring the taxpayer to file a formal claim for refund or credit. Cases of this kind arise when the Treasury's examination shows an overpayment by the taxpayer.

The following instructions have been issued to collectors of internal revenue:

RULING. For the more expeditious handling of refund, credit, and abatement claims, and to provide for the refund or credit of overpayments of revenues where no claims have been filed, the following procedure is established to become effective December 16, 1921:

1. Reduction of internal revenue assessments and adjustments of overpayments of revenues will hereafter be accomplished in one of three ways:

(a) On the basis of an application submitted by a taxpayer on Form 46, 47 or 47A, together with appropriate supporting evidence to be filed in the office of the collector of internal revenue of the district in which the tax is assessed.

(b) On the basis of a certificate of overassessment prepared by the appropriate administrative unit in the Bureau in each case in which an overassessment of tax is disclosed through the audit of a return.

(c) On the basis of a blanket claim (Form 751); a schedule of taxes found to be uncollectible (Form 53); or a schedule of duplicate payments and overpayments due to obvious error on all forms of taxable returns (blanket form 47 or 47B) submitted by a collector of internal revenue. Form 751 will be used only in cases where credit balances exist, regardless of the class of return filed. (T. D. 3260, dated December 8, 1921.)

Item (c) is of interest to collectors only. It is the procedure which must be followed to clear their records.

Forms 46, 47 and 47A have been consolidated into form 843.

Claims for refunds by resident or non-resident aliens.—

RULING. When a claim for refund is filed by aliens, resident or non-resident, on Form 46, a copy of the form upon which the alien was assessed and taxed should be attached to Form 46. (C. B. 1, page 258; O. D. 472.)

Claims for refund must be filed within five years.—The government is required, under the 1918 and 1921 laws to make any additional assessments arising from examinations within five years from the date when the return was due, unless fraud is established. Likewise taxpayers, in order to secure credits or refunds of taxes overpaid, must file their claims before the expiration of five[28] years from the dates when the returns were made.

LAW. Section 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or instalment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided*, That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefore is filed by the taxpayer: *Provided further*, That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section: *And provided further*, That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

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[28] If the claim for refund is not occasioned by the fact that an examination of the taxpayer's returns discloses an overpayment, the claim for refund must be filed within five years from the date the tax was paid. See page 263.

The 1918 law was changed by adding that part which starts with "Provided further."

Under this provision the Treasury may grant refunds for all years subsequent to 1909 when based upon inadequate depreciation or other deductions to which the taxpayer was entitled in such years. These refunds must be made in connection with examination of returns made under the 1917, 1918 or 1921 laws.

Many concerns have paid additional taxes assessed for 1916 and prior years which should now be refunded unless the procedure under memorandum 106[29] and the *La Belle Iron Works* case[30] makes the application for refund undesirable.

RULING. Reference is made to a letter of April 7, 1921, wherein the following statement was made and questions asked:

The taxpayer's books and accounts are examined by a revenue agent. The agent finds that for the year 1914 the taxpayer has overpaid the amount of tax due. He also finds that the taxpayer owes additional tax for the year 1916, and in the adjustment of the agent's report the overpayment for 1914 is applied as a credit against the additional tax found due for 1916 and the balance of the 1914 overpayment is refunded. It later develops that the taxpayer instead of being liable for additional tax for the year 1916, as found by the revenue agent, has overpaid his tax for that year. The taxpayer files a claim for credit of this overpayment against tax due for subsequent years. The question presented is, how much tax may be assumed to have been paid by the taxpayer for the year 1916, i.e., the amount actually paid in cash or the cash payment plus the credit on account of the overpayment for 1914?

If it is held in the foregoing that the taxpayer has paid the cash payment plus the amount credited on account of the overpayment for 1914, and a claim for refund is filed, how should the refund claim be adjusted?

It is to be understood that in both instances mentioned above no record of a credit for overpayment of 1914 tax against additional tax originally found due for the year 1916 appears on the assessment list.

The Government in the present instance was expressly authorized to refund the taxes erroneously collected or to accept such taxes as a credit. The credit having been duly made, it seems clear that if the real remedial purpose of section 252 is to be effected, "paid" must be construed in its broader sense as including a credit duly made. It is accordingly held that where there has been an overpayment of

[29] See Appendix A, Chapter VIII.
[30] Advance opinions 65 L. Ed., page 604.

taxes on an income return for a certain year and within five years from the date the return was due the overpayment is credited to taxes due on an income return for a subsequent year, such credit constitutes payment or part payment of the taxes for the year in which it was applied.

In reply to your second question, you are advised that the cash payment plus the amount allowed as a credit on account of the overpayment for 1914 should be adjusted for the year 1916 where the taxpayer files a claim for refund covering the latter year.

The fact that no record of a credit for overpayment of 1914 taxes appears on the 1916 assessment list does not affect the treatment of the credit as a payment for the year 1916, where the credit was in fact made within five years from the date the 1914 return was due. (C. B. 4, page 336; Sol. Op. 107.)

Section 3228 of the Revised Statutes was amended to read:[31]

LAW. Section 1316. [Section 3228, Rev. Stat.] **All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum.**

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

The foregoing section of the Revised Statutes differs from the 1918 law in two respects:

1. The period is changed from two to four years.
2. Time is computed from the date of payment instead of from the date "after the cause of action accrued."

Generally speaking, the distinction between section 252 and section 3228 (Revised Statutes) is that the former applies only to income, excess profits and war profits taxes; while the latter applies to all taxes specified in the Revenue Act. Furthermore,

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[31] Before amendment this section read as follows:

Law. Section 3228. [Rev. Stat.] "All claims for the refunding of any internal tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within two years next after the cause of action accrued. . . . ."

under section 3228 relief is granted in cases not covered by section 252. Section 252 computes time "from the date when the return was due." Section 3228 determines time from the date of payment. Further, section 252 relates to claims for refund occasioned by examinations of a taxpayer's income and profits tax returns, whereas section 3228 refers to any claim for refund originating in any other manner.

Some time during 1919, the opinion of the Solicitor was requested as to whether or not section 3228 of the Revised Statutes permits the filing of claims for refund of taxes paid under any of the acts specified in section 252 of the Revenue Act of 1918 after five years from the date return was due.

RULING. . . . . The view has been expressed that section 252 does not repeal section 3228, but merely supplements the latter, and whatever rights a taxpayer may have under section 3228 are preserved and further extended by section 252. In other words, it is said that a claim for refund may be filed under section 252 within five years after the due date of the return for the year involved, and that a claim for refund may also be filed within two years after payment of the tax, or the time when the cause of action accrued, as provided in section 3228. This construction is advanced for the reason that taxpayers would otherwise have no relief by way of filing claims for refund with reference to assessments under the Revenue Act of 1918, made just prior to the date when the five-year limitation expired.

No suit may be brought for the collection of any taxes alleged to have been erroneously collected until an appeal has been made to the Commissioner of Internal Revenue and a decision of the Commissioner has been had therein. (R. S. 3226.) Consequently if the taxpayer is required to pay the taxes assessed against him at a time when the period within which a claim for refund may be filed has expired he could never maintain a suit to recover the taxes paid. Nor could the collection of the tax be enjoined. It is therefore held that section 252 of the Revenue Act of 1918 was not intended to take away the right given a taxpayer under section 3228 of the Revised Statutes to make a claim for refund within two years after the cause of action accrued or the date of the payment of the tax under protest. As another has said, "perhaps the mere textual construction is in favor of the other view," but a contrary construction would not be harmonious with the spirit of the present law, which is designed to grant relief in cases when Revised Statutes 3228 works injustice. . . . . (B. 4-19-235; O. 833.)

The foregoing interpretation also applies to section 252 of the 1921 law.

Interpretation of section 252.—The following questions and answers regarding section 252 of the 1918 law were prepared for the guidance of the Income Tax Unit. These interpretations also apply to the 1921 law.

RULING. Q. What is the closing date governing the five-year limitation?

A. Five years from the date on which the return for the year involved was due to be filed (taking into consideration any extension of time granted for filing the original return).

(a) Returns for 1913 which were due to be filed March 1, 1914, have as their closing date March 1, 1919. Does this mean that the warrant must be actually issued by the Commissioner before the expiration date March 1, 1919, or will the auditor's results of the examination of the return be the governing date?

A. With respect to this question there appears to be an inaccuracy in statement. The question speaks of the warrant for payment of a claim for refund as being issued by the Commissioner. Such is not the practice. The Commissioner signs the allowance schedule, and the warrant is issued by the Division of Bookkeeping and Warrants after the allowance has been passed upon by the Auditor for the Treasury Department. The correct answer to this question, therefore, is that the schedule authorizing the allowance of a claim for refund must be actually signed by the Commissioner within five years from the date when the return was due, taking into consideration any extension of time granted for filing the original return.

(b) Does the fact that a revenue agent's report, or a valuation engineer's report, determining an overpayment within the five-year period, is not audited until after the five-year limit, bar the auditor from allowing same as an offset, it being recognized that taxpayer is not in possession of the valuation engineer's finding and in some cases not in possession of the revenue agent's report, and, therefore, could not have filed claim within the five-year limitation?

A. Neither a refund nor a credit claim could be allowed under these circumstances. If a claim for refund is filed and the overpayment considered in connection with the refund claim, it would be barred by the five-year limitation. If it is proposed to allow credit for the overpayment, the fact that an overpayment has been made is not conclusively determined until audit of the agent's or engineer's report which is subsequent to the expiration of the five-year limitation.

(c) The auditor in auditing a case finds overpayment for 1913 and offsets this overpayment in an A-2 letter to taxpayer dated February 25, 1919. The taxpayer takes exception to depletion allowed and after several conferences with the valuation engineers a greater depletion for all years is allowed and a reaudit of his return is made October 10, 1919. The five-year limitation on 1913 has expired at the time the latter audit was made. Can this credit be allowed in view of the fact that a portion was allowed in the audit of February 25, 1919, or is the entire amount now barred by the statute? Had the taxpayer filed a claim for abatement of the 1913 taxes prior to payment thereof, would that have operated to his advantage?

A. The additional overpayment determined subsequent to the expiration of the five-year limitation could neither be refunded nor credited.

Relative to the second question in (c), it appears that the principle laid down by the Supreme Court in the case of the Rock Island, Arkansas & Louisiana Railroad Company versus The United States in a decision rendered November 22, 1920 (Income Tax Service Ruling 1-21-1380), is equally applicable to the present case. As stated in the above-cited case, the regulations have established a procedure and a form to be used in an application for abatement and separate and distinct ones for a claim for credit or a claim for refund. A taxpayer must file claim for the relief sought, i.e., a claim for credit, if a credit is what is desired or is required. Section 252 of the Revenue Act of 1918 provides in part as follows:

No such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of five years a claim therefor is filed by the taxpayer.

The language of the statute is clear. If at the expiration of five years from the date the return was due no credit or refund has been allowed by the Commissioner and no claim for either a credit or a refund has been filed by the taxpayer, then the taxpayer is precluded from relief under either of the methods provided by law. A claim for abatement does not take the place of a claim for credit. These are two separate and distinct claims, and although the result accomplished may be the same in both cases, nevertheless, the requirements of the statute are not satisfied by permitting the use of these two claims interchangeably.

(d) A taxpayer, on April 15, 1918, filed amended returns for 1913 and subsequent years which showed an overpayment for 1913. The amended returns were not audited until July 1, 1919—four months after the expiration of the five-year limitation placed on the original return. Does the filing of an amended return within the five-year period act in the same capacity as a claim, as far as being allowed

to offset the overpayment against an additional tax, or is it barred due to the fact that the final audit was not reached before the expiration of the five-year limitation on 1913 return?

A. The same principle applies as in (c). Amended returns do not take the place of a claim for refund or credit, and if filed, unsupported by such claim or claims, do not in themselves constitute a sufficient claim within the meaning of the statute to warrant the crediting or refunding of any taxes thereunder after the expiration of the five-year period.

(e) A revenue agent's report dated May 8, 1919, discovers additional tax for the year 1913, $150.00. Waiver was secured and the additional tax was assessed and paid by taxpayer November, 1919.

In a reaudit of this case, based on conference held in the Unit with taxpayer, additional depletion was allowed in which the correct tax for 1913 was determined to be $100.00.

Thus:

Original return filed	No tax due
A-2 letters, November, 1919—tax due	$150.00
Correct tax assessable for 1913—October, 1920, audit	100.00
Overassessed and paid	50.00

As the original return as filed reported no income, therefore no tax, the first assessment against the taxpayer appears in A-2 letter of November, 1919, against the year 1913 for $150.00.

The final audit of October, 1920, determines the tax to be $100.00. Can the overpayment for 1913, made by the assessment letter of November, 1919, be offset against an additional tax for subsequent years, due to the fact that the only assessment made for 1913 was made on a revenue agent's report dated May 8, 1919, in which insufficient depletion was allowed by the revenue agent?

A. No offset or credit can be allowed. Notwithstanding the fact that the assessment for 1913 was made and paid in 1919, no credit for overpayment for refund was allowed or made within five years from the date when the return was due, and none can be allowed or made subsequently under section 252 of the Revenue Act of 1918. Section 3220 of the Revised Statutes, however, authorizes the Commissioner of Internal Revenue to refund taxes erroneously collected, but the claim for refund thereunder must be presented to the Commissioner within two years next after the cause of action accrued, as required by section 3228 of the Revised Statutes. The taxpayer in this case, therefore, is confined to his rights under section 3220, R. S., but any claim for refund of overpayment of taxes based on this section must be made within two years after the date of payment thereof. (C. B. 4, page 332; M. 2764.)

Revival of claims for refund for 1914 and prior years.—The Treasury during 1920 issued a ruling holding that claims for refund pending at the time the 1918 law was passed, could not be allowed.[32]

These claims have been revived by the following provision of the 1921 law:

LAW. Section 252. . . . . nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

Payment of refunds.—

LAW. Section 1315. That section 3220 of the Revised Statutes, as amended, is reenacted without change, as follows:

"Section 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; . . . ."[33]

The Solicitor issued the following opinion interpreting the 1918 law. It is equally applicable to the 1921 law.

RULING. . . . . Section 3220, Revised Statutes, was amended by Congress at the instance of the Treasury Department. Before amendment section 3220, Revised Statutes, provided that the Commissioner could remit or refund taxes subject to regulations made by the Secretary only upon appeal to him made. The Treasury Department believed that a taxpayer should in every case be advised of every overpayment of tax and that the overpayment should be refunded, and it was believed that it would facilitate the work of the Internal Revenue Bureau if the Commissioner could make a refund without the necessity of a claim being filed. It was not the intention of the Treasury Department that the Commissioner should have authority to allow claims which were barred by any statute of limitation, or to refund a tax where the taxpayer had no right to file a claim for the refund therefor. It was apparently not the intention of Congress to make it possible for the Commissioner, subject to regulations made

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[32] C. B. 3, page 302; Sol. Op. 79. For the author's criticism of this opinion, see *Income Tax Procedure,* 1921, pages 214-215.

[33] Section 1323 (section 1316 of the 1918 law) re-enacts section 3225 of the Revised Statutes which limits refunds to cases in which the return was not *wilfully* false.

by the Secretary, to ignore statutes of limitation. It must therefore be held that the Commissioner has authority to refund a tax only in a case where a claim has been filed which is not barred by any statute of limitation or where the taxpayer has a legal right to file a claim for the refund of the tax. (C. B. 3, page 302; Sol. Op. 79.)

Suits for recovery must be started within five years after payment.—An appeal to the Commissioner in the form of a claim for refund is the first step in seeking relief by a taxpayer. If the Commissioner delays action on claim for refund, suit may be brought against the collector after six months, without awaiting the Commissioner's decision.

LAW. Section 1318. That section 3226 of the Revised Statutes is amended to read as follows:

"Section 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of five years from the date of the payment of such tax, penalty, or sum."

This section shall not affect any suit or proceeding instituted prior to the passage of this Act, but shall apply to all suits and proceedings instituted after the passage of this Act, whether or not barred by prior Acts of Congress.

The change in the above section reduces the time in which claims for refund may be filed and suits instituted.[34]

For instance, if taxpayers file claims for refund four years, six months and one day after the day the tax was paid and the Commissioner does not render a decision within six months, suits cannot be instituted. No suit can be instituted "after the expiration of five years from the date of the payment of the tax."

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[34] [Former Procedure] For details of procedure under former laws, see *Income Tax Procedure*, 1921, page 220.

The Treasury will probably not be able to pass upon all 1917 and 1918 claims before the expiration of five years. Taxpayers, therefore, should be careful not to permit the period to expire before instituting suit.

Section 3227 of the Revised Statutes has been repealed. This repeal does not, of course, affect any suit or proceeding as described in section 3227, instituted prior to the 1921 law.[35]

Before this section was repealed it was possible to postpone suit for six years or more.[36] The government in the case of *Rockefeller v. United States of America* (unreported) asserted that the claim was barred two years and six months after the appeal to the Commissioner. The United States Supreme Court considered this case on its merits, hence this decision may be accepted as finally disposing of this point.

Suits must now be instituted within five years after payment.

Proof of appeal to Commissioner.—The court of claims of the United States has decided that when suit is brought by a taxpayer against the collector for recovery of the tax, the burden of proof is upon him to show that his appeal to the Commissioner has been taken and decided, or else that decision was delayed more than six months from the date of appeal.[37]

DECISION. The written appeal was the best evidence of which the case was susceptible and if it was not in his power to have produced the original it was, nevertheless, his duty to have produced an authentic copy thereof, or accounted for its absence.[38]

DECISION. The lodging of an appeal (claim for refund) made out in due from with the proper collector of internal revenue, for the purpose of transmission to the commissioner in the usual course of business under the requirements of the regulations of the secretary, was in legal effect a presentation of the appeal to the Commissioner.[39] (Reg. 33, 1918, Art. 270.)

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[35] Section 1319.
[36] See *Income Tax Procedure*, 1921, pages 219 and 220.
[37] *Lauer v. U. S.*, 5 Ct. Cl. 447.
[38] *Hubbard v. Kelly*, 8 W. Va. 46.
[39] *U. S. v. Savings Bank*, 14 Otto 728; 104 U. S. 728; 26 L. Ed. 908; 28 Int. Rev. Rec. 87.

Claim for abatement does not constitute an appeal to the Commissioner.—Two recent decisions, one by the United States Supreme Court, the other by the Circuit Court of Appeals for the Eighth Circuit, conflict on the question as to whether or not the filing of a claim for abatement acts as an appeal to the Commissioner. Of course, the decision of the Supreme Court controls; but since the reasoning of the Circuit Court is more logical and appears to be the more reasonable interpretation of the law, both decisions are quoted.

Decisions. This is a claim for a sum paid as an internal revenue tax under the Act of August 5, 1909, c. 6, §38, 36 Stat. 11, 112. It is alleged that the claimant was not engaged in or doing business in the year for which the tax was collected and that therefore it was not due. The Court of Claims dismissed the petition on the ground that the claimant had not complied with the conditions imposed by statute and the claimant appealed to this court.

The facts are simple. After the tax was assessed a claim for an abatement was sent to the Commissioner of Internal Revenue in July, 1913. On December 18 of the same year the Commissioner rejected the application, whereupon on December 26 the claimant paid the tax with interest and a penalty. So far as appears there was no protest at the time of payment and it is found that after it nothing was done to secure repayment of the tax. By Rev. Stats., section 3226, amended by Act of February 27, 1877, c. 69, § 1, 19 Stat. 248, no suit shall be maintained in any court for the recovery of any tax alleged to have been illegally assessed "until appeal shall have been duly made to the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof, and a decision of the Commissioner has been had therein, provided," etc. Regulations of the Secretary established a procedure and a form to be used in applications for abatement of taxes and distinct ones for claims for refunding them. The claimant took the first step but not the last.

By Rev. Stats., section 3220, the Commissioner of Internal Revenue is authorized "on appeal to him made, to remit, refund, and pay back" taxes illegally assessed. It is urged that the "appeal" to him to remit made a second appeal to him to refund an idle act and satisfied the requirement of section 3226. Decisions to that effect in suits against a collector are cited, the latest being *Loomis v. Wattles* (266 Fed. Rep. 876). But the words "on appeal to him made" mean, of course, on appeal in respect of the relief sought on appeal—to refund if refunding is what he is asked to do. The words of section 3226 also must be taken to mean an appeal after payment, especially

in view of section 3228 requiring claims of this sort to be presented to the Commissioner within two years after the cause of action accrued. So that the question is of reading an implied exception into the rule as expressed, when substantially the same objection to the assessment has been urged at an earlier stage.

Men must turn square corners when they deal with the Government. If it attaches even purely formal conditions to its consent to be sued those conditions must be complied with. *Lex non praecipit inutilia* (Co. Lit. 127b) expresses rather an ideal than an accomplished fact. But in this case we cannot pronounce the second appeal a mere form. On appeal a judge sometimes concurs in a reversal of his decision below. It is possible as suggested by the Court of Claims that the second appeal may be heard by a different person. At all events the words are there in the statute and the regulations, and the Court is of opinion that they mark the conditions of the claimant's right. See *Kings County Savings Institution v. Blair* (116 U. S. 200). It is unnecessary to consider other objections that the claimant would have to meet before it could recover upon this claim.[40]

The right of the plaintiff to maintain this suit is challenged in this court for the reason that the plaintiff did not appeal to the Commissioner of Internal Revenue after the tax was paid. This contention is based upon section 3226, Rev. Stat. U. S. (Comp. Stat., section 5949). The object of the statute requiring a party to exhaust his remedies in the Internal Revenue Department before he shall bring suit is to give the department an opportunity to decide whether in its judgment the tax is legal or illegal, and thus save the delay and expense of litigation. The point under consideration was not made in the court below, nor is it mentioned in the assignment of errors; but, as it may be claimed to be jurisdictional, it will be considered. We had a similar question before us in *Weaver v. Ewers* (195 Fed. 247, 115 C. C. A. 219), and we then held that, notwithstanding section 3226, an appeal to the Commissioner, before the tax was paid, answered the purpose for which the statute was enacted. In the case cited we said:

"What the Commissioner of Internal Revenue thought about the assessment had been obtained upon full statement of the facts, and it would have been a useless form again, after the tax was paid, to appeal to the Commissioner and obtain the same judgment. The reason for the appeal did not exist, and hence the appeal after tax was paid was not necessary."

The following cases sustain our ruling: *Schwarzchild, etc., Co. v. Rucker* (C. C., 143 Fed. 656); *San Francisco Sav. & Loan Society v. Carey* (2 Sawy. 333, Fed. Cas. No. 12,317); *Grier v. Tucker*

[40] *Rock Island, Arkansas & Louisiana Railroad Co. v. U. S.*, November 22, 1920, 254 U. S. 141.

(C. C., 150 Fed. 658); *Tucker v. Grier* (160 Fed. 611, 614, 615, 87 C. C. A. 513); *De Bary et al. v. Dunne* (C. C., 162 Fed. 961).

Counsel for defendant cites *Savings Bank v. Blair* (116 U. S. 200, 6 Sup. Ct. 353, 29 L. Ed. 657); *Stewart v. Barnes* (153 U. S. 456, 14 Sup. Ct. 849, 38 L. Ed. 781); and *Hastings v. Herold* (C. C., 184 Fed. 759). These cases have been examined, and when the facts of each case are considered they sustain the ruling of this court in *Weaver v. Ewers, supra.* We therefore see no reason for departing from the ruling heretofore made, and hence decide that the contention is without merit.[41]

It should be noted that the foregoing case is cited by the Supreme Court, but is dismissed with the statement that the words "an appeal" mean an appeal after payment. It is therefore important that taxpayers file a claim for refund after a claim for abatement is rejected if they wish to reserve their legal rights.

The 1921 law amended section 3226, Revised Statutes, making it more specific as to the nature of the "appeal . . . . to the Commissioner of Internal Revenue,"[42] which is a prerequisite to bringing suit for refund and to which reference was made in the Supreme Court's opinion in *Rock Island, Arkansas and Louisiana R. R. Co. v. United States.*[43] The section as amended by the 1921 law states that "no suit . . . . shall be maintained . . . . until a claim for refund or credit has been duly filed with the Commissioner. . . . ."[44]

Suit must be brought against collector who collected tax and not against his successor.—The United States Circuit Court of Appeals for the Seventh Circuit certified the following two questions to the United States Supreme Court:[45]

DECISION. 1. Assuming that the declaration states a good cause of action had the suit been brought against S. M. Fitch, the internal revenue collector who actually collected and received the taxes, does it state any cause of action whatever against said S. M. Fitch's suc-

[41] *Loomis v. Wattles,* 266 Fed. 876.

[42] The text of section 3226, Rev. Stat., as it appeared before amendment by the 1921 law, appears in *Income Tax Procedure,* 1921, page 216.

[43] 254 U. S. 141.

[44] See page 263 for text of section 3226, Rev. Stat., as amended.

[45] *Smietanka v. Indiana Steel Co.,* advance opinions, 66 L. Ed. page 3.

cessor in office, the plaintiff in error, against whom the suit was brought, but who had no participation in the collection, receipt or disbursement of such taxes?

2. May suit in the district court of the United States properly be brought and maintained against a United States collector of internal revenue for the recovery of the amount of a United States internal revenue tax, unlawfully assessed and collected, but in the collection and disbursement of which such collector had no agency, the entire transaction of such assessment, collection, and disbursement having occurred during the incumbency of such office of a predecessor in office of such collector?

The court answered both questions in the negative.[16]

Suits where collector is dead.—Prior to the passage of the 1921 law, if the amount involved exceeded $10,000, suit could not be brought in a federal district court if the collector were dead, but the Court of Claims had sole jurisdiction. Section 1310 (c), by an amendment of section 24 of the Judicial Code, now gives a district court concurrent jurisdiction with the Court of Claims in such circumstances.

LAW. Section 1310. . . . . (c) Paragraph Twentieth of section 24 of the Judicial Code is amended by adding at the end thereof the following new paragraph:

"Concurrent with the Court of Claims, of any suit or proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal-revenue laws, even if the claim exceeds $10,000, if the collector of internal-revenue by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."

State courts have no jurisdiction to determine federal taxes.—Two interesting cases[17] have been decided by the Supreme Court of Errors for the State of Connecticut.

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[16] The District Court for the Southern District of Ohio, Western Division, has made a similar ruling. *Cincinnati Gas & Electric Co. v. Gilligan* (not reported). See B. 29-21-1738; Ct. D. 16. See also *Philadelphia, Harrisburg & Pittsburg R. R. Co. v. Lederer,* 242 Fed. 492.

[17] *Willmann, et al. v. Walsh,* 112 Atl. 804; and application of *Willmann, et al.* 112 Alt. 806.

RULING. Under the Connecticut laws of 1918 (Sections 3446 and 3447), upon voluntary dissolution of a corporation, upon vote of the stockholders, the directors are made trustees in the liquidation of the affairs of the corporation. Such trustees may apply (Section 3448) to the Superior Court for the county in which such corporation is located for the limitation of a period for the presentation of claims against the corporation. Upon the limitation of such a period by the court, it is provided that such trustees shall proceed to wind up the affairs of the corporation under the direction of the court in the same manner as if they were receivers. It is provided (Section 3449) that any claim not presented within the time limited shall be barred, unless the owner thereof shall commence an action to enforce the same within four months after notice from the trustees of rejection. (T. D. 3166.)

The facts of the two cases and the decision of the lower court appear in the following ruling:

RULING. On February 27, 1919, Joseph Willmann, et al., trustees in liquidation, petitioned the court for the issuance of an order limiting a period within which all claims against the corporation should be presented and for such additional orders from time to time relative to the winding up of the affairs of the corporation as might be proper and necessary in accordance with the statutes of the State of Connecticut. On the same date the Superior Court for New Haven County, Connecticut, issued an order providing that all claims against the Derby Manufacturing Company should be presented to said trustees within four months from February 27, 1919. Among the claims presented pursuant to this order was one of the United States, presented by James J. Walsh, Collector of Internal Revenue for the District of Connecticut for additional income, excess profits and war profits taxes for the years 1916, 1917 and 1918; and also for taxes not then determined for that portion of 1919 up to the date of the cessation of business by such corporation.

On June 1, 1920, the trustees reported the claims of the United States wherein they disallowed the major portion thereof. The court entered an order approving the report and providing that written notice should be given to the United States, through the Commissioner of Internal Revenue, and to James J. Walsh, Collector, that unless the disallowed portion of the claim was made the subject of application to the court for allowance within two weeks, the same should be barred. Thereafter, the United States Attorney for the District of Connecticut filed a petition on behalf of the United States for the allowance of the entire claim. On June 29, 1920, the trustees in liquidation filed with the court an application for a restraining order against the collector, asking that the collector be restrained

from interfering with their possession of the company's property, notwithstanding the fact that there was pending in this office a claim in abatement covering the taxes in question, during the pendency of which no distraint proceedings would have been carried out by the collector. It was alleged that the trustees were officers of the court and that an interference by the collector with their possession would be a contempt of the court. Upon the hearing of this application, the Superior Court of New Haven County refused to grant the restraining order. Thereafter, on September 20, 1920, the trustees filed another application for a restraining order and for instructions from the court as to the duty of the trustees in relation to such claims of the United States, and for a hearing by the court to determine what taxes, if any, were due the United States. This application was made upon the theory that the trustees in liquidition were officers of the court, in view of the fact that in winding up the affairs of the corporation they were subject to the orders of the court, and that, in order that proper instructions might be issued to them in connection with the Government's claim for taxes, the court should hear and determine the proper amount due and that the collector should be restrained from taking any steps to distrain upon the company's property in the satisfaction of any sum in excess of the amount the court should allow. On October 15, 1920, upon hearing such application, the Superior Court was of the opinion that it had no jurisdiction to hear and determine the claim of the United States for taxes and that the assessment of the Commissioner of Internal Revenue was conclusive upon it. The court directed the trustees to pay the Government's claim for taxes, authorizing them to take steps to protect the estate of the corporation by way of claim for refund and suit to recover back the taxes paid. Judgment was therefore entered in favor of the United States. From this order and judgment, and from the order denying the application of the trustees dated June 29, 1920, an appeal was taken to the Supreme Court of Errors for the State of Connecticut as above indicated. (T. D. 3166, dated May 19, 1921.)

The higher court affirmed the lower court's decision in each case. In commenting upon the second case, the higher court said:[48]

Decision. The facts found disclose that the federal taxes involved in these proceedings have not been paid, and that a claim for the abatement of said taxes is pending before the Commissioner of Internal Revenue, under Section 5949 (Sec. 3226, R. S., U. S.) of the Compilation of United States Statutes, 1916. Under such facts, in accord with the terms of Section 5949 (Sec. 3226, R. S., U. S.)

[48] *Ibid.*

no suit, formal, or as here, informal, can be maintained to recover back or to abate such federal taxes in any court, state or federal. Under Section 5947 of such Compilation no suit, formal or informal, can be maintained to restrain the collection of federal taxes. Therefore the superior court had no jurisdiction to pass upon the legality of the assessment of the internal revenue taxes in question, or to issue a restraining order relating thereto, because of the provisions of the United States Statutes quoted above.

Suit to recover may include penalties improperly collected.—If an illegal tax is paid, the fact that it was not paid within the time allowed by law will not prevent any taxpayer from recovering the penalty of 1 per cent a month paid by him for non-payment; for if the tax was illegal it was never due and therefore the penalty was as much unauthorized as the tax itself.[49]

Interest allowable on refunds, whether granted by the Commissioner or the courts.—Contrary to all previous laws, the 1921 law provides that interest must be paid upon all claims for refund or credit allowed. The section seems to apply to refunds arising under all previous laws and covers all internal revenue taxes. Interest when allowed is allowable on all claims, whether voluntarily allowed by the Commissioner or by the courts.

LAW. Section 1324. (a) That upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest shall be allowed and paid upon the total amount of such refund or credit at the rate of one-half of 1 per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest setting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" as used in this section means a further assessment for a tax of the same character previously paid in part.

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[49] *Camp Bird v. Howbert*, 262 Fed. 114. Certiorari denied March 8, 1920, 252 U. S. 579.

(b) Section 177 of the Judicial Code is amended to read as follows:

"Section 177. No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal-revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal-revenue laws."

It is important to note that the date when interest begins to run varies with certain conditions. (See article 1040.)

The Judicial Code was also amended so that interest can be paid on all internal revenue claims allowed by the Court of Claims. Prior to the passage of the 1921 law, the courts had held that in suits against collectors interest was payable from the date of payment of an illegal tax.[50]

Decision. The defendant's contention that interest was not allowable we cannot uphold. We have very lately been told that—

> "No one could contend that technically a judgment of a District Court in a suit against the collector was a judgment against or in favor of the United States." (*Sage v. U. S.*, 250 U. S. 33, 39. S. Ct. 415, 63 L. Ed. 828, May 19, 1919).

Consequently no question of allowance of interest or costs as against the sovereign arises and the suit is to be regarded . . . . as against a private person. . . . .

It is also urged that interest should not have been allowed as complained of, because the Commissioner signified his willingness to return that amount to plaintiff. Whether plaintiff would have prejudiced this suit by taking what it could get and suing for the rest is a matter not before us. It is enough to repeat that in this action the defendant, even though he has the United States behind him, is to be treated as a private person. . . . .

The important point to be noted is that the Treasury, after long delay, decided that the taxpayer was right and offered to

[50] *New York Life Insurance Co. v. Anderson*, decided January 14, 1920, 263 Fed. 527; affirmed 269 Fed. 1021. A writ of certiorari was granted March 28, 1921 (advance opinions, 65 L. Ed. 587; 41 S. Ct. 449). Writ was set aside on April 18, 1921 (advanced opinions, 65 L. Ed. 591; 41 S. Ct. 534). The application for the writ was finally denied May 2, 1921 (advance opinions, 65 L. Ed. 699; 4 S. Ct. 536).

pay the claim without interest. Since the taxpayer had lost the use of his money for seven years he very properly claimed interest. Upon refusal of the Treasury to pay he brought suit and secured judgment.

Any interest received, whether by suit or not, should be credited to interest. Such interest is taxable income.

When taxes are erroneously assessed limitation does not apply.—It has been held by the Treasury that, whereas suits against the collector must be brought within five years after the payment of the tax, the limitation does not necessarily apply when the tax has been erroneously assessed by the United States.[51]

When suit is brought may the government open up the entire return?—

Ruling. . . . . Where an action for money had and received is brought against a collector of internal revenue for the amount of an additional tax paid on net income, the taxpayer is entitled to recover only such amount as is in reality greater than the tax which should have been assessed under the law as properly interpreted and applied. The fact that the Commissioner in assessing the tax erroneously allowed some deductions for depreciation does not operate as an estoppel against the collector or against the United States, as it is well settled that no assessment of the Commissioner is necessary for the collection of the tax, at least in a direct action by the United States; nor does it make any difference that an assessment has been made, for in spite of the assessment and of the expiration of the period within which an amended assessment can be made, the United States may still sue for the amount actually due. It is immaterial that suit is in form against the collector, because the recovery in the end comes from the United States, so that even if the collector were personally estopped, that estoppel under the circumstances does not apply against the United States. The conclusion is reached therefore that sums due the United States as determined by the court in suit against a collector of internal revenue are a valid offset as against the amount found due the taxpayer, though such sums include items which the Commissioner did not claim to be due the United States when considering the return for purposes of assessment. (C. B. 1, page 258; T. D. 2882 (2).)

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[51] See *Income Tax Procedure*, 1921, page 322.

This might have been true so far as the laws prior to the 1918 act were concerned, when the government could bring suit at any time. Section 250 (d) of the 1921 act provides that no suit may be brought by the Commissioner after the expiration of a certain period.

If the limitation period has run against the government before any counterclaim is made, it is doubtful if the entire return may be opened up. If a taxpayer filed a claim for refund for a certain item and also instituted suit within the limitation period, the government would certainly contend that the suit could include only the specific item claimed. In other words, after the period had expired, the claim could not be amended to include other items.

The District Court for the Western Division of the Western District of Missouri[illegible] has held that a suit may not include items which have not been presented to the Commissioner. The following statement is taken from the Treasury publications:

> Ruling. A taxpayer can not claim a deduction in court for the first time where, in its claim for refund filed precedent to bringing suit, it did not claim the right to such deduction or assert that it had failed to take it in computing net income in its return, or that it had failed to take credit for it, and where, consequently, a claim for the deduction was never presented to the Commissioner of Internal Revenue for his decision. (B. Digest 18-21-1611; T. D. 3164; Ct. D. 11.)

Claim for refund of sums recovered by suit.—The following regulation sets forth the detailed procedure necessary when a taxpayer makes claim for the refund of taxes or penalties erroneously collected by the government after suit has been brought and judgment secured.

> Regulation. (*a*) Claims by taxpayers for the amount of a judgment representing taxes or penalties erroneously collected should be made on form 843. The claimant should state the grounds of his claim under oath, giving the names of all the parties to the suit, the cause of action, the date of its commencement, the date of the judgment, the court in which it was recovered, and its amount. To this

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[illegible] *[illegible]*, 274 Fed. 125.

affidavit there should be annexed a certified copy of the final judgment, a certificate of probable cause, and an itemized bill of the costs paid receipted by the clerk or other proper officer of the court, together with a certified copy of the docket entries of the court in the case or so much thereof as may be required by the Commissioner. When a recovery is had in any suit or proceeding against a collector or other internal revenue officer for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution shall issue against such collector or other officer, but the amount so recovered shall, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury. . . . . (*b*) If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name. There should also be a certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, with a detail of all items of costs which were paid by the judgment debtor or for which he is liable. (Art. 1051; Reg. 45, Art. 1038.)

Method of paying refunds.—

LAW. Section 1317. That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Validity of tax may be determined by Bankruptcy Court.— In the case of *In re General Film Corporation*,[53] the government filed proofs of claim against the bankrupt for additional taxes and interest. The trustee in bankruptcy objected to the claims and the court disallowed them. The government claimed

[53] *U. S. v. Kellogg*, 274 Fed. 903.

that the only remedy open to the trustee for correcting any error was to pay the taxes and then proceed under Rev. Stat. Sec. 3226, by appealing to the Commissioner for refund and subsequently bringing suit. It was held that under Section 64 (a) of the Bankruptcy Act the government's claims were not to be ordered paid as a matter of course and the trustee remitted to proceedings for refund, but that the validity of the tax was a question to be passed upon by the Bankruptcy Court in the first instance.

The court said:

Decision. We regard this section (Section 64(a) of the Bankruptcy Act) as binding upon the government because it is named therein and, while conferring priority, as giving the bankruptcy court the power to hear and determine any question that arises as to the amount or legality of a tax assessed by it. The provision applies to taxes of all the persons mentioned, and we could not differentiate the government from the other persons in the absence of language justifying it.

But section 3226, U. S. Rev. Stat., could under no circumstances apply to the case under consideration because the trustee is not seeking to maintain a suit for the recovery of internal revenue taxes illegally assessed. *Clinkenbeard v. United States*, 21 Wall. 65, 22 L. Ed. 477; *United States v. Nebraska Distilling Co.*, 80 Fed. 285, 25 C. C. A. 418.

Refunds will not be entertained by either Commissioner or courts where a final determination has been had.—Sections 1312 and 1313 of the 1921 law provide that the taxpayer and the Commissioner may by agreement finally close a case. After this agreement has been made, neither may reopen the case.

These sections are discussed in detail in Chapter VIII, pages 210-211.

Action to recover when government claims fraud or understatement.—

Law. Section 1323. That section 3225 of the Revised Statutes of the United States, as amended, is reenacted without change as follows:

"Section 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."

The foregoing section contains a very material improvement in that understatements or undervaluations must be willfully false or fraudulent. In the 1916 law the word "willfully" in the next to last line and the word "willful" in the last line did not appear.[54]

Credits

Prior to the passage of the 1918 law, each year's taxes stood alone. A taxpayer was not allowed to offset one year's taxes against overpayment for previous years. Congress recognized that this was an injustice; so the claim for credit was created.

When may a claim for credit be filed?—

Law. Section 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the government, and for other purposes," the Revenue Act of 1916, as amended, or the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, ...

Regulation. Any amount of income, war profits or excess profits tax paid in excess of that properly due shall be credited

[54] For text of decisions under 1916 law, see *Income Tax Procedure*, 1920, pages 211-212.

against any such taxes due from the taxpayer under any other return. To obtain such credit the taxpayer should proceed as follows:

(1) Where the credit demanded is equal to or less than any outstanding assessment of tax, a taxpayer desiring to obtain such credit shall file with the collector for the district in which his original return was filed a claim on Form 843, which shall be sworn to and shall contain the following statements: (*a*) business engaged in by claimant; (*b*) character of assessment; (*c*) amount of tax claimed as a credit; (*d*) unpaid assessment against which credit is asked and for what taxable year; and (*e*) all facts regarding the overpayment.

(2) Where the amount claimed as a credit is greater than the outstanding assessment of tax, a taxpayer desiring to obtain such credit and the refund to which he is entitled shall file, Form 843, stating thereon the respective amounts claimed as a credit or as a refund. All the facts regarding the total overpayment should be stated in the claim. (Art. 1034.)

Claim for credit may be applied only against over-payment of "Income, War Profits, or Excess Profits Tax."—

Ruling. Munitions tax overpayments for one year may not be credited against an additional assessment of munitions taxes for a subsequent or prior year.

Munitions tax overpayments may not be credited against additional assessments of income, excess profits and war profits taxes for the same or for any subsequent or prior taxable year. (C. B. 4—Digest, page 330; A. R. M. 123.)

Collector must receive clearance before accepting claim for credit.—Many taxpayers after having filed claims for refund also filed claims for credit against current taxes. The result was that the Treasury often had a claim for credit and refund covering the same item. It is understood that in many cases both claims were allowed, which, of course, means the taxpayer got more than he was entitled to.

Taxpayers should notify the Commissioner to reject claim for refund before filing claims for credit with the collector for the same item. This is a reasonable requirement. Taxpayers should not be required to wait more than a reasonable time for the Commissioner's rejection of the claim for refund.

Regulation. Upon receipt by the collector of a claim for credit on Form 843, he will make proper record thereof in his office and,

except in the case of claims covering tax assessed on the basis of returns on Form 1040 A, forward the claim immediately to the Commissioner irrespective of whether or not a claim for refund of the tax now claimed as a credit has previously been filed. Due notice will be given the collector and the taxpayer of the action taken on the claim.

If a claim is allowed against additional taxes due for other years, but such other taxes have not yet been assessed, only the amount of the excess of such taxes over the overpayment shall be assessed, or the excess of the overpayment over such taxes due shall be refunded as the case may be. The effective date of the filing of a claim for credit shall be the actual date of presentation to the collector. The filing of a claim for credit against the tax due under another return shall be subject to the same rules with respect to the addition of interest and penalties as if the taxpayer had filed a claim for abatement of the tax against which credit is desired.

Under no circumstances will a taxpayer be entitled to credit for an alleged overpayment of tax prior to the allowance of such credit by the Commissioner. An attempt to take a credit prior to such allowance shall not be held to be the filing of a claim under section 252 of the Revenue Act of 1921. (Art. 1035.)

RULING. Receipt is acknowledged of your letter of April 18, 1921, stating that your office has already filed a number of claims for credit in connection with the 1920 returns of your clients, in accordance with the provisions of Article 1035 of Regulations 45. As this procedure appears to be in conflict with the requirements of Treasury Decision 3154, dated April 12, 1921, however, you request to be advised whether Treasury Decision 3154 was intended to be retroactive and, if so, to what extent?

In reply, you are advised that Treasury Decision 3154 amending Article 1035 of Regulations 45, became effective on the date of its approval, April 12, 1921, and applies to all claims for credit filed on or after that date.

Taxpayers, however, who had claims for refund on file with the Department, and converted these claims into claims for credit in accordance with the regulations in effect prior to the issuance of Treasury Decision 3154, should request the Commissioner to reject such refund claims and consider only their claims for credit. (Letter to Klein, Hinds and Finke, New York, N. Y., signed by Acting Commissioner M. T. West, and dated May 9, 1921.)

Taxpayers wishing to substitute claims for credit in place of claims for refund should direct their requests to the Commissioner at Washington. Such requests are generally complied with very promptly.

RULING. Receipt is acknowledged of your letter dated October 25, 1921, relative to submitting claims for credit to be considered in lieu of claims for refund already on file in this office.

In reply you are advised that in accordance with the provisions contained in T. D. 3154, it is necessary for the claimant to request the rejection of any claims for refund covering the same period and including the same items as the credit claim which he desires to file before the latter can be accepted. This substitution may be greatly expedited, however, if the claimant's request is made direct to this office. Steps have been taken to insure the rejection of such claims in the shortest possible time and the letters notifying the claimants of the action taken are sent out immediately.

A copy of the letter of rejection should be attached to the claim for credit and filed with the Collector of Internal Revenue for the taxpayer's District. . . . . (Letter to The Corporation Trust Company, signed by Deputy Commissioner E. H. Batson, by C. B. Allen, Head of Division, and dated Nov. 9, 1921.)

Time when credit is made or allowed.—In response to several questions submitted by the Unit, the Solicitor has issued the following opinion:

RULING. The reference, in effect, asks advice whether in a case where a claim for credit has not been filed by the taxpayer a credit for an excess of tax assessed for a prior year may be made or allowed if the examination of the return was made and the excess amount determined upon within the five-year period of limitation named in section 252, and the taxpayer within the limitation period was advised of the amount due on subsequent returns after the credit had been applied; but after the limitation period has expired the Department reconsiders and finds that a mistake was made in the amount of the tax due on the subsequent returns and the excess amount originally found as a credit (*a*) has not been changed, (*b*) should be increased, (*c*) should be decreased. It is assumed from the reference that the assessment represented by the original letter of advice to the taxpayer was not made. If it was made there would seem no room for doubt, since clearly the credit was made when the assessment list went out and any reduction or increase of tax would have to be accomplished by abatement or refund or further assessment.

The question presented depends for solution upon what constitutes the making or allowance of a credit within the meaning of section 252. A statement contained in a letter from the Department to a taxpayer that the taxpayer is entitled to a credit is clearly not a credit actually made or allowed. Something must be done in a formal way that will amount to a direction to the collector who is charged

with the collection of internal taxes. Prior to such a direction he has nothing to do with the taxpayer's account since it has not assumed that status of an account stated to him. Such direction by the Commissioner is usually made by formal assessment list signed by him. When such a formal statement or direction to the collector is signed by the Commissioner and forwarded to the collector, showing the amount of the tax to be collected over and above the credit, the Commissioner has formally made or allowed the credit. When this is done the credit has been made or allowed, but prior thereto anything that is done in the way of stating the case by employees of the Bureau or in the way of statements to the taxpayer in letters from the Department can be nothing more than preliminary to the actual making or allowance of the credit by the Commissioner.

This is true where credits are considered and passed upon formally by the Commissioner. Where, however, the collector because of the provisions of the statute and regulations made pursuant thereto makes the credit without specific instructions from the Commissioner, the credit is actually made or allowed when the collector so records it, and in such a case subsequent action by the Commissioner in the way of a review of the collector's action, would not operate to fix the time when the credit was made or allowed, since in such a case the collector had before him the account of the taxpayer and is charged by law and the regulations to enter the credit.

It is held that where the allowance of a credit as provided in section 252 of the Revenue Act of 1918 is being considered by the Commissioner, the credit is made or allowed only when the Commissioner signs and forwards to the collector a formal statement or direction or assessment list showing the amount of the tax to be collected over and above the amount of the credit. (C. B. 4, page 339; Sol. Op. 106.)

It is important that the privilege of filing claims for credit should not be abused, and the Treasury is justified in strictly interpreting the law. It is not unreasonable to require full compliance with the provisions regarding claims for refund.

It should be noted, however, that the Solicitor did not answer the question: "Did the taxpayer as a matter of fact make what might reasonably be deemed to be a claim for refund within the limitation period?"

Effect of a claim for credit.—The following memorandum by the Committee on Appeals and Review very aptly describes the function of a claim for credit:

RULING. A . . . . credit can not be made until the facts have been carefully examined and the validity of the credit approved by the Commissioner. That is not to say, however, that a claim for credit has no effect until approved. The *claim* for credit may have precisely the same effect as a *claim* for abatement; that is, by forbearance of the collector it may suspend collection until it is acted upon by the Commissioner. If approved, credit is then given relieving both the collector and the taxpayer from any further liability. If rejected, interest is to be paid upon the amount suspended from the time it was due.

This view of the law appears to be entirely consistent with its language and also with the purpose which it was believed Congress had in mind; that is to say, relief to the taxpayer from being required to pay into the Treasury amounts, possibly large, at the same time that he is making a bona fide claim that other amounts are due him. As held in Law Opinion No. 957, it does not prevent the collector, if he so desires, from proceeding to collect at once just as he may do in the case of an abatement claim filed, but leaves it optional with him to suspend collection until such time as credit is given relieving both him and the taxpayer. (B. 19-20-924; A. R. M. 46.)

Law Opinion 957[55] took the position that in order to credit an amount of tax against an overpayment for previous years, such overpayment must have been actually ascertained. The above ruling is in accord with the law and is observed in present procedure.

Place of filing claim for credit when district is changed.—

RULING. Where a corporation filed a return for 1918 with the collector of one district and a return for 1919 with the collector of another district, and subsequently rendered an amended return for 1918, showing less tax liability, together with a claim for credit against the outstanding tax due for 1919, covering the overpayment to the extent shown by the amended return, it should file the amended return with the collector with whom the original return was filed for the year 1918.

The claim for credit should be filed with the collector with whom the return for 1919 was filed, who should forward same to the collector with whom the return for 1918 was filed, for a notation thereon of the facts required by the certificate on the reverse side as to the assessment overpaid for 1918. When this has been done it will be returned by him to the collector with whom the 1919 return was filed, who will make a notation thereon as to the 1919 assessment to

[55] C. B. 1, page 256.

be credited, and forward same to the Commissioner of Internal Revenue for consideration.

In filing the amended return the taxpayer should call attention to the fact that a claim for credit of the overpayment has been filed with the collector with whom the 1919 return was filed, and the collector with whom the claim for credit was filed should be notified that an amended return has been filed. (B. 48-20-1327; O. D. 740.)

Claim for credit in case of affiliated companies.—

RULING. Upon the audit of the returns of several affiliated companies for the period 1909-1917, inclusive, it is found that certain of these companies are entitled to refund on account of excess taxes paid during that period. On the basis of the consolidated return for 1918, covering these companies, it appears that assessment of additional taxes will be required. The question therefore arises whether refunds due the subsidiary companies may not be used as a credit against the additional tax to be assessed on the basis of the consolidated return.

For the purposes of the income tax Acts each affiliated corporation is considered a separate and distinct entity even though a consolidated return is submitted on behalf of all. A claim for credit or refund of excess tax paid by one of the affiliated corporations can be made only by the corporation entitled to receive such credit or refund. Thus with respect to refunds, credits, and additional assessments each affiliated corporation occupies a status similar to that of an independent and unaffiliated corporation. The additional tax assessed for the year 1918, on the basis of the consolidated return for that year, must be apportioned among the affiliated corporations, and to the extent that each debtor corporation is entitled to receive back a part of the taxes paid in prior years, a claim for credit may be filed and the amount of additional tax each subsidiary is required to pay may be reduced thereby by the amount it is entitled to receive. In case the amount payable to the subsidiary exceeds its proportionate part of the additional tax assessed under the consolidated return, it may file a claim for refund for the difference. A subsidiary which is required to pay additional tax and is at the same time entitled to receive back in the form of a refund a portion of the amount paid as taxes in prior years, may, however, within its option pay the entire amount of the additional tax and file a claim for refund for the entire amount it is entitled to receive. (B. 41-20-1237; O. D. 683.)

Affiliated companies may apportion any tax assessed against them on any basis upon which they may agree; therefore apportionment should be made so as to exhaust the entire amounts due from the government for prior years.

May partners apply a credit against overpayment made by a partnership under the 1917 law?—

Ruling. Excess profits tax paid by partnership with respect to income received during 1918 can not be applied as credit to tax due from individual members for taxable year 1918. In such cases claim for refund on Form 46 should be filed by the partnership. (B. 7-19-310; O. D. 180.)

The 1917 law subjected all partnerships to an excess profits tax. As the 1918 act was not approved until 1919, many partnerships with fiscal years ending in 1918 made returns and paid such taxes for a part of 1918.

From an administrative point of view, the above ruling may be correct, but legally the partners are entitled to credit additional taxes against their pro rata amount of the refund.

Claim for credit when a partnership was incorporated prior to July 1, 1919.—

Ruling. Returns for 1918 were filed for a partnership and its members in accordance with the Revenue Act of 1917, prior to the passage of the Revenue Act of 1918, and tax paid accordingly. The partnership was incorporated prior to July 1, 1919, and elected to be taxed as a corporation under the provisions of paragraph 3, section 330, Revenue Act of 1918. Amended returns for 1918 showing overpayment of tax were filed by the partners.

There is no provision in the law whereby either the tax by the partnership or any excess tax paid by the partners may be credited against any tax liability of the successor corporation for any year. Remedy may be sought only by the partnership and the individual members thereof filing claims for the refunding of any excess tax paid. (C. B. 2, page 247; O. D. 457.)

There is no reason why the above credit should not have been allowed, because the stockholders in the new corporation were the partners in the partnership. (See C. B. 3, page 310; O. D. 757.)

When successor corporation may file credit against overpayment of predecessor.—

Ruling. In view of the fact that the statute of New Jersey under which a merger or consolidation of corporations resulting in the

formation of another corporation is accomplished provides, in effect, that the successor corporation shall represent predecessor corporations in the enforcement of their rights, it is held that the successor corporation is entitled to file claim for credit on account of the overpayment of tax by the predecessor corporation. (C. B. 4, page 335; O. D. 950.)

Claim of credit may be filed by either husband or wife.—

Ruling. Where claims for the refund of taxes erroneously paid for 1919 and prior years have been filed by the husband as a result of the Attorney General's ruling relative to community property under the laws of Texas (T. D. 3071), such claims for refund may be converted into claims for credit to be applied against any taxes due from the husband or wife as shown by separate returns filed by them for the taxable year 1920 and subsequent years, subject to the provisions of section 252 of the Revenue Act of 1918. Such claims for credit must be accompanied by an agreement signed by the husband and wife consenting to the adjustments therein demanded. A claim for refund may be filed for any excess of the amount claimed as a credit over taxes shown to be due. (C. B. 4, page 335; O. D. 854.)

Claim for credit arising from joint return.—

Ruling. The taxpayer's wife in 1918 filed a return showing a substantial net income upon which she paid the tax. Inasmuch as the taxpayer had a net loss for such year he filed no return. The taxpayer intends to file an amended joint return for himself and wife for 1918 and a claim for credit of the excess tax paid for that year to be applied against any tax due for the taxable year 1921.

Held, that a single claim for credit may be so applied against any outstanding taxes due at the time the claim for credit is filed, providing an agreement signed by the taxpayer and his wife consenting to the adjustments therein demanded accompanies such a claim. However, if no outstanding taxes are due by the taxpayer or his wife, a claim of refund of the excess taxes paid for 1918 should be filed, accompanied by the agreement by the taxpayer and his wife referred to. (I-2-23; I. T. 1162.)

Claims for credit may be applied against refunds due under the undistributed profits tax of the 1917 Act.—

Ruling. The tax imposed on undistributed net income of corporations by section 10 (b) of the act of September 8, 1916, as amended by the act of October 3, 1917, is held to be an income tax within the meaning of section 252 of the Revenue Act of 1918

and may, therefore, be credited against an additional amount of income tax due from the taxpayer within the limitations of that section. (B. Digest 1-20-662; O. 974.)

Payment Under Protest

Payment under protest unnecessary to support claim for refund.—In no event is it necessary to pay under protest to secure a legal right to demand a refund when it is believed that the tax has been erroneously assessed. Section 3220 of the Revised Statutes specifically covers this point. The intention of the law is that no one shall be erroneously or excessively taxed. This intention is respected by the Commissioner of Internal Revenue. Sometimes his subordinates or persons in the offices of the collectors, acting with more or less praiseworthy zeal, treat a taxpayer's claim as if it were an attempt to extract money from the United States Treasury under false pretenses. Anyone with a legitimate claim might just as well convey the impression that the United States Treasury retains some of his money, collected under false pretenses.

Both positions are wrong. The claim and its consideration should be as free from technicalities as possible and be made and treated as impartially as a business transaction. The whole matter should be as simple as the filing with a railroad company of a claim for refund of an overcharge. Business men do not hesitate to make these claims against railroad companies, but heretofore they have not been so ready to go after tax overcharges. The reference to railroad claims excludes the period during which the railroads were under government control.

It has been recommended by some authorities that all taxes reported, whether in any case they are more or less than the correct amount, should be paid under protest, not to acquire any right to claim a refund (that being possible without question), but to establish a perfect foundation for a suit against the collector if the claim for refund is rejected. The theory

is that if payment is made voluntarily, in full knowledge that the tax is erroneous, the taxpayer is estopped from any right to succeed in an action at law.

If, as stated elsewhere, payment has been made without any knowledge of the illegality of the assessment, an action can be maintained for that reason. Furthermore, even where a claim has been made for abatement (before paying the tax) and it is refused, and notice is served by the collector that the tax must be paid or penalties will be enforced, it is evident that the payment is being made not voluntarily, but under duress, and the courts hold that collections in such circumstances do not estop the payer from subsequent action at law.

Should payment ever be made under protest?—In the case of an additional assessment after examination, where the facts upon which the government bases its claims are, in the opinion of the taxpayer, unfounded and illegal, there can be no harm, when making the payment, in attaching thereto a simple form of protest. For instance, little trouble is involved in attaching to the remittance this notice:

> I hereby protest against the assessment of the tax levied against me as evidenced in notice dated ...., on the ground that it is erroneous and illegal, and payment is hereby made solely to prevent the imposition of penalties threatened and the attachment of my property.

Protest not necessary under certain conditions.—In one class of cases it certainly is not necessary to have paid under protest—that is, where a taxpayer prepared his returns in accordance with Treasury regulations, believing them to be correct, and having been assessed thereon paid the tax in due course.

In the cases of *Greenport Basin and Construction Company v. United States*, and *Young v. United States*,[56] the court said, after quoting section 252 of the 1918 law, that:

[56] 269 Fed. 58.

DECISION. Under the act, therefore, the refund is a matter of right, without proof of duress or protest. It has been so held under a similar statute. *U. S. v. Hvoslef*, 237 U. S. 1, 35 Sup. Ct. 459, 59 L. Ed. 813, Ann. Cas. 1916A, 286.

Even if it were necessary to plead duress or protest, the petition or complaint sets forth that the defendant computed the tax under compulsion of the regulations and filed a claim for abatement of the taxes assessed before payment. This complies with every requisite of a payment under protest. *Chesebrough v. U. S.*, 192 U. S. 253, 24 Sup. Ct. 262, 48 L. Ed. 432; *City of Philadelphia v. Collector*, 5 Wall. 720, 18 L. Ed. 614. The government urges that it is necessary to make a protest at the time of actual payment, but it seems to the court that this would be a useless requirement. The objects of the protest are to define the taxpayer's attitude and to notify the government thereof. These have been fully accomplished by the objection of the taxpayer when the computation was made and by the filing of his claim.

When payment should be made under protest.—While involuntary payment need not be made under protest in order to secure a refund in the manner provided by the act, in cases where recovery of taxes alleged to be illegally exacted is sought by an action at law, the federal courts have held that the claimant must show involuntary payment. In *City of Philadelphia v. the Collector*,[57] the United States Supreme Court said:

DECISION. Where the party voluntarily pays the money he is without remedy; but if he pays by compulsion of law, or under protest, or with notice that he intends to bring suit to test the validity of the claim, he may recover it back, if the assessment was erroneous or illegal, in an action for money had and received.

In the case cited, *Elliott v. Swartwout*,[58] the court said:

DECISION. It is therefore to be considered as a voluntary payment by mutual mistake of law; and in such case, no action will lie to recover back the money. The construction of the law is given to both parties, and each presumed to know it. Any instructions from the Treasury Department could not change the law or affect the rights of the plaintiff. He was not bound to take and adopt that construction. He was at liberty to judge for himself, and act accordingly.

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[57] 5 Wall. 720; 72 U. S. 720; 18 L. Ed. 614.
[58] 35 U. S. 137; 12 Curtis 46; 9 L. Ed. 373.

. . . . There can be no hardship in requiring the party to give notice to the collector that he considers the duty illegal, and put him on his guard, by requiring him not to pay over the money. The collector would then be placed in a situation to claim an indemnity from the government. But if the party is entirely silent and no intimation of an intention to seek a repayment of the money; there can be no ground upon which the collector can retain the money, or call upon the government to indemnify him against a suit. It is no sufficient answer to this that the party cannot sue the United States. The case put in the question is one where no suit would lie at all. It is the case of a voluntary payment under a mistake of law, and the money paid over is to the treasury; and if any redress is to be had it must be by application to the favor of the government, and not on the ground of a legal right.

Court held that in case of mistake of law, protest was necessary to suit. In case of mistake of fact, such protest was not necessary.

It should be noted that the foregoing case was decided in 1836.

Arguments in favor of paying under protest.—Although the Treasury unreservedly states that a tax, if excessive, need not have been paid under protest to be recovered, there are certain cases which indicate that a taxpayer should pay under protest to protect his right to sue for refund. They are, however, not entirely clear and it will be found that the modern tendency is to waive the formal protest.

The following cases are illustrative of past practice:

Wright v. Blakeslee, 101 U. S. 174, 25 L. Ed. 1048 (1880) holds that, although no written notice or protest is required by statute of a party paying illegal taxes under the internal revenue laws, in order to recover the amount erroneously paid, he must, however, pay under protest in some form, or his payment will be deemed voluntary.

As stated by Chief Justice Fuller, in *Chesebrough v. United States.*[59]

Decision. The rule is firmly established that taxes voluntarily paid cannot be recovered back, and payments with knowledge and without compulsion are voluntary. At the same time, when taxes

[59] 192 U. S. 253; 48 L. Ed. 432; 24 S. Ct. 262 (1904).

are paid under protest that they are being illegally exacted, or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, a recovery in such suit may, on occasion, be had, although generally speaking, even a protest or notice will not avail if the payment be made voluntarily, with free knowledge of all the circumstances, and without any coercion by the actual or threatened exercise of power possessed, or supposed to be possessed, by the party exacting or receiving the payment, over the person or property of the party making the payment, from which the latter has no other means of immediate relief than such payment.

In *Herold v. Kahn,*[60] the court said:

DECISION. The proper administration of the fiscal affairs of the government, require that the payment of taxes should not be delayed by disputes as to their legality, but that the taxes should first be paid and all questions in regard to them be determined in suits brought for their refunding. It is a wise policy, therefore, that encourages the payment under protest of disputed taxes. Though there is some conflict in the dicta of the Supreme Court, we think that the true doctrine is that, when taxes are paid under protest that they are being illegally exacted, or with notice that the payor contends that they are illegal and intends to institute suit to compel their repayment, a sufficient foundation for such suit has been established.[61]

Procedure of Collectors

The procedure of collectors regarding claims for abatement and refund is not of general interest to taxpayers and is omitted from this book.[62]

[60] 159 Fed. 608; 86 C. C. A. 598.

[61] The mandate was recalled and amended in 163 Fed. 947; 90 C. C. A. 307, so as to include interest from the date of the judgment of the District Court.

[62] See T. D. 3260.

CHAPTER X

INFORMATION AT THE SOURCE

The provisions of the 1918 law requiring certain information returns have been re-enacted in the 1921 law in identical terms.

The system of information at the source was introduced in the 1917 law with a dual purpose—to obtain an effective method of check regarding certain classes of income included or which should be included in tax returns, and to remove the causes of complaint leveled at the provisions of the 1913 and 1916 laws regarding withholding of tax at the source.

"Collection before receipt," as withholding has been called, was, and still is, a salient feature of the British income tax law; but its adoption in this country proved too technical and unsuited to American conditions.

The use of information returns, now in force, provides a method of supplying the taxing authority with a vast amount of accurate information regarding taxable income which, if used intelligently, will enable the government to obtain almost as definite a hold on the income in question as if the tax had been withheld by the payor.

It is important that those responsible for the filing of information returns become cognizant of the requirements of the law, not only as an assistance to the government but also in order to prevent the infliction of penalties on themselves for non-compliance. The farmer paying a foreman $90 a month must be educated to obey the law just as much as a corporation which pays its president $9,000 a month.

Information returns on *all* payments would result in the submission of an immense amount of material, a large part of which would be entirely valueless. The framers of the law made it discretionary with the Commissioner, subject to cer-

tain limitations, as to the type of returns that may be demanded. For this reason, the regulations make very full provisions as to the information returns required.

Classification of information returns.—Returns of information may be divided into the following groups:

1. Returns for all payments of fixed and determinable income, such as interest (other than bond interest), rent, wages, salaries, fees, commissions, etc., payable to citizens or residents and to foreign partnerships.
2. Ownership certificates which must be used in collecting interest on foreign and domestic corporation bonds, and dividends on foreign stocks.
3. Withholding returns in the case of all payments of fixed and determinable annual or other periodical income payable to non-resident alien individuals and foreign corporations.
4. Returns of payments of domestic dividends.
5. Returns of payments of profits to clients by brokers.
6. Returns disclosing actual ownership of stock made chiefly by foreign principals.

The pages immediately following deal with returns for payments of fixed or determinable income, while the subject of ownership certificates is covered in the latter part of this chapter. Withholding returns are discussed in Chapter XI.

Payments of Fixed or Determinable Amount

Who must furnish information as to payments of salaries, interest, rent, etc., of $1,000 or more.—

LAW. Section 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers,

The classes to which paid.—

making payment to another individual, corporation,[1] or partnership,

[1] Payments to corporations need not be reported (Art. 1074).

Description of payments.—

of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), [The exceptions are dividends and transactions by brokers (see page 302)].

The amount to be reported.—

of $1,000 or more in any taxable year,

Employees of United States government must make return.—

or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for,

Form of returns.[2]—

shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment. . . . .

The regulation dealing with this matter follows:

REGULATION. All persons making payment[3] to another person of fixed or determinable income of $1,000[4] or more in a taxable year must render a return thereof to the Commissioner for the preceding calendar year on or before March 15 of each year, except as specified in articles 1073, 1074, 1075, 1076, and 1079. The return shall be made in each case on Form 1099, accompanied by a letter of transmittal on Form 1096 showing the number of returns filed. The street and

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[2] **[Former Procedure]** Under the 1913 and 1916 laws there were provisions for withholding at the source for all classes of fixed and determinable annual or periodical income. These withholding returns constituted a source of information, but "information at the source" in the strict sense was first provided for in 1917 law. This system was substituted where withholding at the source was abolished. The provisions of the 1918 law regarding information are substantially the same as those of the 1917 law.

[3] These returns are required for actual amounts *paid or credited and made available* during the calendar year equal to or exceeding $1,000. (C. B. 2, page 249; O. D. 428.)

[4] **[Former Procedure]** Under the 1917 law the amount to be reported was an annual aggregate of $800.

number where the recipient of the payment lives should be stated, if possible. Where no present address is available, the last known post-office address must be given. Although to make necessary a return of information the income must be fixed or determinable, it need not be annual or periodical.[5] (Art. 1071.)

The new article omits the requirement of reporting on form 1096 the aggregate amount represented by the separate form 1099. The new form only requires a statement of the number of forms 1099 attached thereto.

RULING. A receiver in partition proceedings is required to file returns of information covering payments of commissions, attorney's fees, and other fixed or determinable income of $1,000 or more made to any person during the taxable year. (B. 52-21-1995; O. D. 1149.)

Returns cover calendar year.—

LAW. Section 256. . . . . The provisions of this section shall apply to the calendar year 1921 and each calendar year thereafter, ...

The instructions on form 1099 (1920) state:

One of these forms must be filled in for each person to whom income, as described on this form, was paid during the calendar year. . . . .

Fixed and determinable income defined.—The law requires returns of information only when the income is fixed and determinable. It is not necessary that the income be annual or periodical, as stipulated in the requirement for withholding.

REGULATION. . . . . (*a*) Income is fixed when it is to be paid in amounts definitely predetermined. On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. . . . . (Art. 362.)

It has been held that where a lease provides for a payment of rental in crop shares, the landlord and tenant sharing proportionately the expenses and dividing the proceeds, such pay-

[5] Where withholding is required the income must be annual or periodical as well as fixed and determinable.

ments are not fixed and determinable and need not be reported.[6]

Commission on account of a single transaction has been held not to be fixed or determinable annual income.[7] Income credited but not paid is subject to the provisions of article 362.[8] Fees for professional services should be included in information returns.[9] Earnings of lawyers and doctors are not usually within the purview of this provision of the law (unless they are paid a regular retainer).[10]

Payments to employees.—Returns of information regarding payments to employees, other than those against whom withholding is required, are specifically covered as follows:

REGULATION. The names of all employees to whom payments of $1,000 or over a year are made, whether such total sum is made up of wages, salaries, commissions, or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. In case an employer has a large number of employees and the computation of exact amounts paid during the calendar year will result in an undue hardship, careful estimates may be made on the basis of any representative month, and unless the yearly payment based on this estimate in the case of any employee amounts to $1,000 or more, no return of payments to such employee is required. (Art. 1072.)

The new regulation permits employers who have a large number of employees to make returns on *estimated* payments. The old regulation extended this privilege only to employers having a large number of employees who were being moved from job to job.

To report accurately the payments made to individual employees occasions a great amount of unnecessary expense

[6] Treasury Bulletin "B," page 38; also C. B. 1, page 261; O. D. 115.
[7] C. B. 4, page 232; O. D. 907.
[8] C. B. 2, page 249; O. D. 428.
[9] C. B. 2, page 248; O. D. 416.
[10] Treasury Bulletin "B," page 11.

to many large corporations. It has been ascertained that the production of $1 tax to the government has cost corporations in some cases as much as $10. The new regulation will reduce the labor involved to some extent, but the author is still of the opinion that the requirements of the government, in so far as this particular form of information is concerned, would be amply met if corporations were to report merely the name and address of any employee paid at the rate of $1,000 per annum or over without specifying the exact sum paid.

If an employer is required under a state law to withhold a tax on an employee's salary, the gross payment before deduction should be reported.

RULING. In executing Form 1099, an employer who is required to withhold tax from an employee under a State income-tax law, should report on such form the amount of the salary paid to the employee plus the amount of the tax withheld. The employee should report the same amount in his personal return on Form 1040 or Form 1040A as the case may be. (C. B. 2, page 249; O. D. 401.)

The value of living quarters and board furnished employees[11] must be considered by employers in preparing returns of information:

RULINGS. . . . . A person receives cash compensation for services rendered, and in addition thereto living quarters; when such quarters are furnished for the benefit and convenience of employees, the amount of cash compensation plus the value of living quarters must be returned. When, however, living quarters are furnished for the convenience of the employer only, the value thereof need not be returned. Board and lodging furnished seamen in addition to their cash compensation is held to be supplied for the convenience of the employer. . . . . (Treasury Bulletin "B," page 38.)

The value to a domestic servant of the board and lodging received as part of his compensation for services rendered is deemed to be the same amount which he would be required to pay for board and lodging elsewhere than in his employer's household.

If the value of the board and lodging added to the cash compensation equals or exceeds $1,000 an employer is required to report such amount on Forms 1099 and 1096. The value of the board and lodging

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[11] See Chapter XIV. The 1921 law specifically provides that the rental value of a minister's house is not taxable and should therefore not be reported.

should be entered separately on Form 1099, as evidence of the fact that such value has been considered in computing the total amount received by the servant. (C. B. 4, page 348; O. D. 874.)

In view of the foregoing, employees should be advised by employers regarding the tax to which they are subject.

Return of information by partnerships, personal service corporations, and fiduciaries.—

Information returns on forms 1099 and 1096 are required in all the above cases regardless of whether such income amounts to more or less than $1,000 annually.[12] Salaries paid to members of partnerships or personal service corporations must also be included in the returns of information. Similarly, if a fiduciary receives a salary from an estate, an information return must be filed. All payments by partnerships, personal service corporations, and fiduciaries to employees must be reported if such payments equal or exceed the statutory minimum.

Many taxpayers object to making information returns for members of partnerships and personal service corporations and for beneficiaries, because such information is shown on the partnership return 1065 and the fiduciary return 1041. This duplication of information returns was the subject of a recent conference at Washington between the Secretary of the Treasury and representative bankers and others. It resulted in the elimination of forms 1096 and 1099 in these cases, as stated in the instructions on the new form 1096.

RULING. A business which had been operated as a partnership was incorporated in June, 1920, and thereafter operated as a corporation. There was no interruption to the business, and the employees of the partnership were retained by the corporation.

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[12] See Treasury Bulletin "B," page 30; also C. B. 4, page 348; M. 2708.
[Former Procedure]

RULING. "Form 1099 is required to be filed for the calendar year. A partnership which renders its return on a fiscal year basis should report on Form 1099 the distributive share of each member of the partnership for the fiscal year ending within the calendar year for which the Form 1099 is rendered." (C. B. 4, page 348; O. D. 885.)

Held, that for administrative purposes it will not be considered that there was a change in employer. Since there was no interruption to business, and the employees of the partnership continued to be the employees of the corporation, only one Form 1099 covering the calendar year 1920 is required to be filed in each case where the total amount of payments made equalled or exceeded $1,000. (C. B. 4, page 347; O. D. 788.)

Information returns of bond interest and foreign dividends not limited to payments of $1,000.—The statutory provision as to information returns in case of bond interest and foreign dividends is as follows:

LAW. Section 256. . . . . **Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections**[13] **of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange. . . . .**

Monthly and annual returns required.[14]—The withholding agent is required to make monthly and annual returns as follows:

REGULATION. (*a*) Every withholding agent shall make an annual return to the collector of the tax withheld from interest on corporate bonds or other obligations on or before March 1 on Form 1013. He shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The original ownership certificates, or the substitute certificates where authorized, must be forwarded to the Commissioner with the

[13] **[Former Procedure]**

RULING. "The term 'collections' as used in section 256 of the Revenue Act of 1918 includes the following:

"(*a*) The payment by the licensee of the foreign item in cash;

"(*b*) The crediting by the licensee of the account of the person presenting the foreign item;

"(c) The tentative crediting by the licensee of the account of the person presenting the foreign item until the amount of the foreign item is received by the licensee from abroad;

"(*d*) The receipt of foreign items by the licensee for the purpose of transmitting them abroad for deposit." (I-4-47; I. T. 1176.)

[14] See Chapter XI.

monthly return . . . . the tax withheld must be paid on or before June 15 of each year to the collector. . . . . (Art. 371; Reg. 45, Art. 370.)

The ownership certificates are now to be sent to the Commissioner and not to the collector as previously.

If a non-resident alien claims exemption on tax-free covenant bonds on or before February 1 by filing with the withholding agent form 1001B, the amount of tax due from the withholding agent as shown by form 1013 may be reduced by 2 per cent of the aggregate amount of interest payments made to such individual during the calendar year.[15]

When forms 1001 and 1001A are used *there is no actual withholding,* such returns being simply *information returns.*[16] Monthly and annual returns are nevertheless required.[17]

REGULATION. Where a debtor corporation or its duly authorized withholding agent has made payments of interest on its bonds, but in certain instances has been required to withhold no tax, the ownership certificates on Form 1001 filed in connection with such payments shall be transmitted to the Commissioner, accompanied by a return on form 1096A showing the number of ownership certificates thus transmitted and the total amount of interest paid. This return shall be made by the 20th day of each month following that for which the return is made and need not be sworn to. An annual return shall be forwarded to the Commissioner not later than March 15 of each year on form 1096B, on which shall be given a summary of the monthly returns. . . . . (Art. 373.)

Return of information as to foreign items.—

REGULATION. In the case of collections of foreign items, regardless of amount, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. (*a*) In the case of dividends, as to which the first bank or collecting agent is the source of information, it shall detach the ownership

[15] See Chapter XXXVI for discussion of personal exemption of non-resident aliens.

[16] It should be noted that all withholding returns are treated as information returns and are therefore mentioned in this chapter. All information returns, however, are not withholding returns and this distinction should be noted.

[17] The requirement as to monthly and annual returns covering payments on form 1001A are the same as for 1001. The regulation governing returns on form 1001A is quoted in full on page 316.

certificate and indorse on the item the words, "Certificate detached and information furnished," adding its name and address. When foreign items have been indorsed as above prescribed, the certificates shall be forwarded to the Commissioner on or before the 20th day of the month following that during which the items were accepted, accompanied by a return on form 1096A showing the number of certificates. An annual return on form 1096B shall be forwarded to the Commissioner not later than March 15 of each year, on which shall be given a summary of the monthly returns. (*b*) In the case of interest items, as to which the paying agent or the last bank or collecting agent in this country is the source of information, the ownership certificate shall accompany the coupon to such agent or source of information, who shall forward the ownership certificate to the Commissioner in the same manner as above provided with respect to dividend items. Where ownership certificate Form 1000 is used, a monthly return shall be made on Form 1012 and an annual return on Form 1013, as provided in articles 361-375. . . . . (Art. 1079.)

The name of the paying agent should be shown on forms 1012 and 1013 when they are used to make returns of ownership certificates covering foreign interest. The aggregate amount of foreign items is no longer reported on form 1096A.

The provisions of subdivision (b) above are applicable also to foreign registered bonds.[18]

Information regarding foreign items.—"Foreign items" and the source from which information is obtained are expressly stated as follows:

Definition of "foreign item."—

REGULATION. The term "foreign item," as here used, means any dividend upon the stock of a nonresident foreign corporation or any item of interest upon the bonds of foreign countries or nonresident foreign corporations, whether or not such dividend or interest is paid in the United States or by check drawn on a domestic bank.

Source of information.—

(*a*) Wherever a foreign country or nonresident foreign corporation issuing bonds[19] has appointed a paying agent in this country, charged

[18] C. B. 3, page 313; O. D. 674.
[19] A non-resident corporation is defined as "a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein." "A foreign corporation not engaged

with the duty of paying the interest upon such bonds, such paying agent shall be the source of information. If such foreign country or foreign corporation has no such agent, then the last bank or collecting agent in this country shall be the source of information. (*b*) In the case of dividends on the stock of a nonresident foreign corporation, however, the first bank or collecting agent accepting such item for collection shall be the source of information. No return of information is required with respect to foreign items owned by a nonresident alien individual, a foreign partnership, or a foreign corporation, provided the first bank or collecting agent is satisfied as to such ownership. In such case the foreign item may be stamped "foreign owner." (Art. 1076; Reg. 45, Art. 1077.)

Returns of payments to non-resident aliens.[20]—

REGULATION. In the case of payments of annual or periodical income to nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. (Art. 1075; Reg. 45, Art. 1076.)

Form 1042 is the annual list return of the withholding agent which must be filed on or before March 1.

RULING. A withholding agent is not relieved from obligation to pay to the Federal Government the amount of tax correctly withheld from the income of a nonresident alien by reason of the fact that the nonresident alien has filed a return showing no tax liability. (B. 31-21-1756; O. D. 985.)

Return of payments of dividends.—

LAW. Section 254.[21] That every corporation subject to the tax

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in trade or business within the United States which has a fiscal agent in the United States, is not a resident corporation." See Treasury Bulletin "B," page 10.

[20] There is no withholding on fixed and determinable annual or other periodical income paid to foreign partnerships, except in the case of interest on tax-free covenant bonds. Apparently information returns must be filed on form 1099, in the case of such payments. (Bulletin 1-19-10; O. D. 76.) If the income of non-resident aliens is not fixed or determinable, no information return is required. (C. B. 3, page 312; O. D. 673.)

[21] **[Former Procedure]** Reg. 33, 1918, Art. 33, referred to special Regulations 40, governing returns to be made by brokers, but these were apparently never promulgated.

imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

REGULATION. When directed by the Commissioner, either specially or by general regulation, every domestic or resident foreign corporation and every personal service corporation shall render a return on Form 1097 of its payments of dividends and distributions to stockholders for such period as may be specified, stating the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid him, and when the surplus out of which it was paid was accumulated. (Art. 1060; Reg. 45, Art. 1051.)

Returns of brokers.—

LAW. Section 255. **That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.**[22]

REGULATION. When directed by the Commissioner, either specially or by general regulation, every person doing business as a broker shall render a return on Form 1100, showing the names and addresses of customers to whom payments were made or for whom business was transacted during the calendar year or other specified period next preceding and giving the other information called for by the form. (Art. 1065; Reg. 45, Art. 1061.)

Where no return of information on forms 1099 and 1096 is required.—As previously stated, the statute gives the Commissioner discretionary powers as to the class of payments to be reported on information returns 1099 and 1096. The list of specific payments which require no information returns follows:

[22] [Former Procedure] A similar provision was in the 1917 law, but no return of dividends paid was ever required, except in the case of payments to foreign corporations—these being liable to withholding of the tax.

REGULATION. Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099: (*a*) payments of interest on obligations of the United States; (*b*) dividends paid by domestic or resident foreign corporations; (*c*) payments by a broker to his customers; (*b*) payments of any type made to corporations; (*e*) bills paid for merchandise, telegrams, telephone, freight, storage, professional services, and similar charges; (*f*) annuities representing the return of capital; (*g*) payments of rent made to real estate agents (but the agent must report payments to the landlord if they amount to $1,000 or more annually; (*h*) payments made by branches of business houses located in foreign countries to alien employees serving in foreign countries; and (*i*) payments made by the United States Government to sailors and soldiers and to its civilian employees. (Art. 1073; Reg. 45, Art. 1074.)

The instructions on form 1096 state that no return on form 1099 is required in case of "Distributions to members of a partnership, personal service corporation and beneficiaries."

RULING. An employer is not required to report on Form 1099 the amount representing compensation for personal injuries or sickness paid to an employee. (C. B. 4, page 349; O. D. 858.)

Although several types of income paid by states or political subdivisions thereof are exempt from tax, there are numerous instances in which taxable income is paid. Such taxable income must be reported:

RULING. A department of municipal government is required to file a return of information as provided in section 256 of the Revenue Act of 1918, showing payments of fixed or determinable gains, profits, and income of $1,000 or over in any taxable year, excluding from the return, however, payments made as salary or wages to officials or employees of a State or political subdivision thereof, and payments of interest on the obligations of a State or political subdivision thereof. (C. B. 2, page 249; O. D. 470.)

When extensions of time for certain returns of income[23] have been granted for a period not exceeding ninety days after the proclamation of peace, such extension does not authorize any delay in filing returns of information.[24]

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[23] See page 61.

[24] See article 446, page 60.

Forms of Ownership Certificates and Their Uses

	Domestic bonds		Foreign bonds payable U. S.		Foreign bonds payable abroad		Foreign dividends
	Tax-free	Other	Tax-free*	Other	Tax-free*	Other	
Citizens or residents (exemption claimed)	1001 Line 1	1001 Line 2	1001A Line 1	1001A Line 1	1001A Line 1	1001A Line 1	1001A Line 1
Citizens or residents (exemption not claimed)	1000 Line 1	1001 Line 2	1000 Line 1	1001A Line 1	1001A Line 1	1001A Line 1	1001A Line 1
Domestic partnership‡**	1000 Line 2	1001 Line 3	1000 Line 2	1001A Line 2	1001A Line 2	1001A Line 2	1001A Line 2
Domestic corporation	1001 Line 4	1001 Line 4	1001A Line 3	1001A Line 3	1001A Line 3	1001A Line 3	1001A Line 3
Non-resident alien individuals†	1000 Line 3	1000 Line 3			1001A Line 4	1001A Line 4	1001A Line 4
Foreign Partnership	1000 Line 4	1001 Line 5			1001A Line 5	1001A Line 5	1001A Line 5
Foreign corporation (having office in U. S.)	1001 Line 6	1001 Line 6			1001A Line 3	1001A Line 3	1001A Line 3
Foreign Corporation (no office in U. S.)	1000 Line 5	1000 Line 5			1001A Line 6	1001A Line 6	1001A Line 6
Foreign Government	1001 Line 7	1001 Line 7					
Coupons received without ownership certificate	1000 Line 6	1000 Line 6	1000 Line 6	1001A	1001A	1001A	1001A

*In case of a foreign country or a foreign corporation having a fiscal agent in this country and issuing bonds which contain a tax-free covenant clause, the fiscal agent is required to withhold a normal tax on the interest on such bonds, and the ownership certificate, form 1000 (revised), modified to show the name and address of the fiscal agent, should be used by citizens or residents of the United States, individual or fiduciary, and by domestic or resident partnerships. If a personal exemption is claimed, form 1001A should be used. In all other cases, form 1001A should also be used.

**Personal service corporations use same forms as partnerships up to December 31, 1921, after which date personal service corporations are classed with corporations in general.

†Where non-resident alien claims personal exemption, form 1001B should be executed. (T. D. 2920, September 15, 1919.)

‡See pages 311-312.

Form 1087 (revised), not included in the above table, is for use by a foreign principal (see page 318).

Returns under systems of "information at source" and "payment at source."—Returns by withholding agents, treated in more detail later, are required of the various classes of withholding agents covered by the regulations.

Corporations paying interest on bonds and similar forms of indebtedness are required to report the amount withheld in any month on or before the 20th day of the following month, using for this purpose form 1012. At the close of the year and on or before March 1 of the following year, these monthly returns are summarized on an annual return, using form 1013.

The monthly returns referred to above are not required by the statute, but are demanded under regulations prescribed by the Commissioner as a convenience in reporting this tax. Their purpose is to enable the Treasury to audit and check from month to month the items therein reported, and thus avoid congestion at the close of the year. The annual reports, however, are required by the statute, and failure to file them subjects the withholding agent to penalties the same as those for failure to file the annual returns of net income.[25] An extension of time may be obtained for filing the list returns in the same manner and for the same reasons as those applying to returns of net income.[26]

Tax withheld from income other than bond interest will be accounted for on income tax form 1042, and separate reports of the payments entered in form 1042 will be made on form 1098.

Employers, tenants and debtors must report annually on form 1099[27] amounts of $1,000 or more, paid for salaries, wages, rents, interest, premiums, etc., during the year. In the case of payments of bond interest and collection of foreign dividends the report is not limited to amounts in excess of $1,000. As one person, firm or corporation may find it

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[25] See page 132.
[26] See page 157.
[27] For classes of items to be reported, see page 293.

necessary to fill out more than one form 1099, it will be necessary to accompany the forms with a letter of transmittal, which is known as form 1096. The form used for non-resident aliens is form 1098.

Affiliated corporations do not make a consolidated report for purposes of information. Form 1099 is to be used by each corporation separately in reporting payments.[28]

A graphic chart published by the government (Treasury Bulletin "B") will be found helpful (see page 307).

The chart indicates in heavy-faced type the number of the form at its point of origin. For instance, form 1000, shown in heavy-faced type opposite the caption "Individual or Owner," is made out by the individual or other owner of the securities, and by him is forwarded to the bank or collecting agent. Subsequently form 1000 is shown in light-face type, indicating its receipt and forwarding, respectively, by the bank, the payor, the collector, and finally the Commissioner. Some of the other forms do not pass through as many hands. For instance, form 1087 goes directly from the individual to the Commissioner.

Ownership Certificates

Use of ownership certificates.—Perhaps no feature of our revenue laws has been more confusing to taxpayers than the proper use of ownership certificates. Such certificates are required "for the purpose of effectuating the withholding requirements of the law relating to the payment of tax at the source on bonds and similar obligations, and in order to obtain information at the source."[29] The withholding requirements of the statute regarding tax-free covenant bonds have complicated their use.[30]

Regulation. The owners of bonds or other obligations, except

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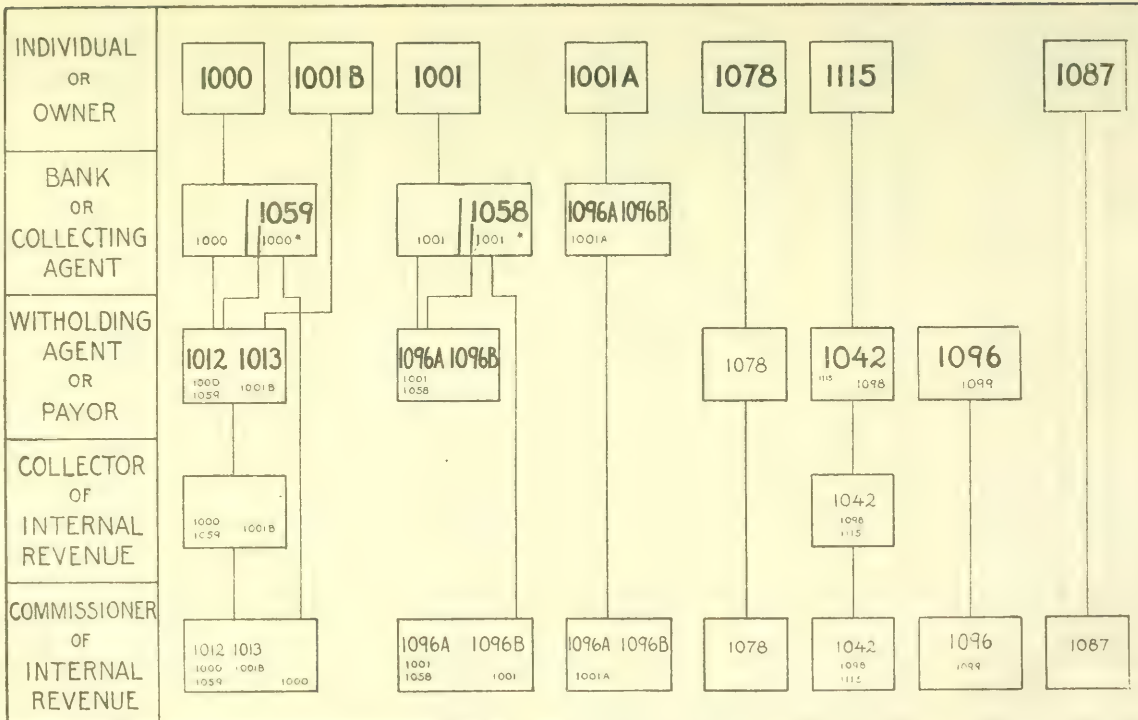
[28] See Appendix B.
[29] Treasury Bulletin "B," page 21.
[30] See Chapter X for discussion of this subject.

GRAPHIC CHART SHOWING ORIGIN AND ROUTE OF FORMS



* Forms 1000 and 1001 go direct to the Commissioner when substitute certificates, Forms 1058 and 1059, respectively, are issued by banks or collecting agents.

Heavy face type indicates origin of form; light face type indicates receipt and forwarding of form. (Treasury Bulletin "B," page 44.)

domestic and resident corporations, whether or not such bonds or other obligations contain a free-tax covenant, issued by domestic or resident foreign corporations, when presenting interest coupons for payment shall file a certificate of ownership for each issue of bonds, showing the name and address[31] of the debtor corporation, the name and address of the owner of the bonds, the nature of the obligations, the amount of interest and its due date,[32] and the amount of any tax withheld. . . . . (Art. 365; Reg. 45, Art. 364.)

Domestic corporations presenting interest coupons for payment need no longer attach ownership certificates. The requirement that ownership certificates should show the marital status of the owner is eliminated.

RULINGS. If banks and other collecting agents accept coupons for collection to which are attached incomplete or otherwise improperly executed ownership certificates, such banks or collecting agents become a party to the filing of incomplete returns of information and shall upon demand of the debtor furnish the name and address of the owner of the coupons so that such ownership certificates may, when filed, be accepted as returns of information in accordance with the provisions of the regulations issued under section 256 of the Revenue Act of 1918. (C. B. 4, page 232; Mim. 2725.)

Since the debentures of the M Company are evidence of indebtedness on the part of the M Company the payments made on the debentures are not dividends but payment of interest. The holders of such debentures are therefore required to file ownership certificates on Form 1001 when receiving payment made by the corporation under the terms of the debenture. (C. B. 4, page 232; O. D. 1060.)

All ownership certificates should contain complete information, or payment should be refused. The interest of the taxpayers and the agents demands this. Taxpayers who fail to file the required form automatically waive the credit which they might otherwise claim for tax constructively withheld at the source. Once a form has been accepted by banks or other collecting agencies, the responsibility for its corrections lies with such banks or agents.[33] They should always bear the

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[31] It is not necessary to enter the street address of the debtor corporation on the ownership certificate. (O. D. 615.)

[32] Bondholders frequently enter the maturity date of the bond, instead of the due and payment date of the coupon.

[33] See page 312.

signature of the owner or his agent. Space is also provided for reporting foreign dividends. The use of ownership certificates takes the place of information returns 1099 and 1096.

REGULATION. In the case of payments of interest, regardless of amount, upon bonds and similar obligations of domestic or resident foreign corporations, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. . . . . (Art. 1074; Reg. 45, Art. 1075.)

The following ownership certificates are now in use:

Form 1000 (revised).[34] Ownership certificate—tax to be paid at source. Interest on bonds and other similar obligations of domestic and resident corporations.

Form 1001 (revised). Ownership certificate—tax not to be paid at source. Interest on bonds and other similar obligations of domestic and resident corporations.

Form 1001A (revised). Ownership certificate—tax not to be paid at source. Dividends on stock of foreign corporations and interest on bonds of foreign countries and foreign corporations.

Form 1001B.[35] Statement of income received by non-resident alien from sources within United States—personal exemption claimed. Used by non-resident to claim exemption on tax-free covenant bonds.

Form 1087 (revised). Ownership certificate—disclosing actual owner of stock. For use of foreign principal to disclose actual ownership of stock of a domestic corporation registered in name of representative in the United States.

Form of certificate when witholding is required.—Withholding at the source is discussed in detail in Chapters XI and XXXVI; but, inasmuch as withholding returns are treated as

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[34] When this form is used there is actual withholding at the source.

[35] Few non-resident aliens claim exemption on tax-free covenant bond interest. Hence this form is seldom used.

information returns, it is deemed advisable to state the regulation governing the use of ownership certificate form 1000 (revised).[36]

Regulation. For the purposes of article 365 Form 1000 shall be used (*a*) by citizens or residents of the United States when no personal exemption or credit is claimed against interest on bonds containing a tax-free covenant; (*b*) by nonresident alien individuals, by partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, and by foreign corporations not engaged in trade or busiess within the United States and not having any office or place of business therein, whether or not such bonds contain a tax-free covenant; (*c*) by partnerships, resident or nonresident, and (prior to January 1, 1922) personal service corporations, in the case of bonds containing a tax-free covenant; and (*d*) where the owner is unknown to the withholding agent. (Art. 366; Reg. 45, Art. 365.)

Partnerships are now included under (c) and claim (d) is entirely new.

Certificates required when there is no withholding.[37]—

Regulation. For the purposes of article 365, Form 1001 shall be used (*a*) by citizens or residents of the United States when personal exemption is claimed against interest on bonds containing a tax-free covenant and when presenting coupons from bonds not containing a tax-free covenant; (*b*) by domestic and resident partnerships, in the case of bonds not containing a tax-free covenant. In case a citizen or resident alien individual receives interest on bonds containing a tax-free covenant in excess of the amount of personal exemption which the individual may claim, any such excess must be reported on Form 1000. (Art. 367; Reg. 45, Art. 366.)

Form 1001 is no longer used by domestic corporations, non-resident partnerships, nor by foreign corporations.

Use of substitute certificates.[38]—

Regulation. Resident collecting agents, including responsible banks and bankers receiving interest coupons for collection with ownership certificates attached, may present the coupons with the

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[36] For monthly and annual returns required, see pages 298-299.

[37] For monthly and annual returns required, see page 299.

[38] Substitute certificates are favored by persons who wish to conceal the identity of bondholders from the debtor corporation or its paying agent.

original certificates to the debtor corporation or its duly authorized withholding agent for collection, or may detach and forward the original certificates directly to the Commissioner, provided each such collecting agent shall substitute for such original certificates its own certificates, Form 1058 or Form 1059, and shall keep a complete record of each transaction, showing (*a*) serial number of item received; (*b*) date received; (*c*) name and address of person from whom received; (*d*) name of debtor corporation; (*e*) class of bonds from which coupons were cut (whether containing a tax-free covenant or not); and (*f*) face amount of coupons. The original certificate for which the certificate of the collecting agent is substituted shall be endorsed, preferably with a rubber stamp, by the collecting agent, as follows:

Owner's certificate No..................

....
(Name of collecting agent.)

..........................., 19....
(Give date of certificate.)

The counterpart of the within certificate bearing like number was attached to the coupons within mentioned for delivery to the debtor or withholding agent, by whom the coupons are payable.

For the purpose of identification the substitute certificates shall be numbered consecutively, reverting to the numeral 1 at the beginning of each calendar year, and corresponding numbers given the original certificates of ownership. The use of substitute certificates by collecting agents, banks, and bankers is not permitted, however, in the case of ownership certificates presented with coupons for collection by nonresident alien individuals, partnerships, or corporations. (Art. 368; Reg. 45, Art. 367.)

Form 1059 is used instead of form 1000; form 1058, instead of form 1001.

Interest coupons presented without ownership certificates.—

REGULATION. When interest coupons are received unaccompanied by certificates of ownership, unless the first bank be satisfied that the owner is a domestic or resident corporation, the first bank shall require of the payee a statement showing the name and address of the payee, the name and address of the debtor corporation, the date of the maturity of the interest, the name and address of the person from whom the coupons were received, the amount of the interest, and a statement that the owner of the bonds is unknown to the payee. Such

statement shall be forwarded to the Commissioner with the monthly return on Form 1012. The first bank receiving such coupons shall also prepare a certificate on Form 1000, crossing out "owner"[39] and inserting "payee" and entering the amount of interest on line 6, and shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank. (Art. 369.)

The affidavit form is no longer required, a mere statement only being necessary. If the first bank is satisfied that the owner of the coupon is a corporation, no statement is now required.

Correction of ownership certificates by banks or other collecting agents.—

RULING. Banks or other collecting agents receiving coupons attached to ownership certificates executed on the wrong form, in order to expedite the collection of the interest, are permitted to transfer the necessary information from the erroneous to the proper form, the following notations being stamped in the lower left-hand corner:

"..............................

(Name and address of bank or collecting agent.)

By ...."

(Name of official executing certificate.)

The original certificate should be forwarded with the certificate executed on the proper form by the bank or collecting agent, the original certificate bearing the notation substantially as follows: "Superseded by ownership certificate Form ....," designating the form of certificate executed by the bank or collecting agent. (C. B. 2, page 192; O. D. 562.)

The Treasury places the burden on the bank or collecting agent to see that certificates are properly made out. By accepting an ownership certificate the bank or agent becomes directly responsible for its being made out in accordance with the requirements of the law and regulations.

RULING. The attention of the Bureau of Internal Revenue has been invited to the fact that in many instances indifference and carelessness has been shown by owners in executing ownership certificates

[39] Line 6 is provided for unknown holders.

accompanying coupons presented to banks and other collecting agents for collection of interest on bonds and other obligations of debtors, and also that banks and other collecting agents have been accepting incomplete and improperly executed ownership certificates with such coupons deposited for collection and have been transmitting same to debtors for payment. . . . . Banks and other collecting agents are not required by law or regulations to accept interest coupons for collection. If, however, as a matter of convenience to their customers, they do accept interest coupons for collection, it is their duty to see that the ownership certificates which are executed by the owner of the coupons are properly filled out. These ownership certificates cannot be accepted as returns of information unless they are properly filled out and debtors receiving coupons from banks or collecting agents with incomplete or otherwise improperly executed ownership certificates are, under the foregoing quoted provisions of Section 256, authorized to demand that the name and address of the owner of the coupons accompanied by incomplete or otherwise improperly executed ownership certificates shall be furnished before the coupons are paid.

If banks and other collecting agents accept coupons for collection to which are attached incomplete or otherwise improperly executed ownership certificates, such banks or collecting agents become a party to the filing of incomplete returns of information and shall upon demand of the debtor furnish the name and address of the owner of the coupons so that such ownership certificates may, when filed, be accepted as returns of information in accordance with the provisions of the regulations issued under Section 256 of the Revenue Act of 1918. (C. B. 4, page 232; Mim. 2725.)

Ownership certificates for bonds sold between interest dates.—

RULING. Where an interest coupon is presented for payment of interest upon a bond which has been sold between interest dates, the coupon shall be accompanied by the ownership certificate of the purchaser only, and the certificate should cover the full amount of the coupon. The purchaser may, if he does not claim exemption from having the tax paid at the source, take credit in his return for the tax paid at the source on the entire amount of interest represented by the coupon. The discrepancy between the amount of bond interest reported in the purchaser's return in such cases, and the amount of interest shown by his ownership certificates to have been collected by him should be explained by a statement attached to and made a part of the return, showing the total amount of interest collected and the amount of interest accrued on the bond to the date of purchase. (C. B. 4, page 232; O. D. 830.)

The foregoing ruling is an exact reversal of the Treasury's former procedure[40] which called for certificates of ownership from both vendor and purchaser, the interest being apportioned between them. The change in procedure does away with a needless duplication of certificates and still supplies the required information regarding the allocation of interest. It tends, however, to impose a deprivation on the vendor, where such vendor is an individual and not a corporation. Under the ruling the vendee is entitled to take credit for the tax paid at source on the *entire* amount of interest represented on the coupon. The value of the coupons is $100, the amount thereof accrued to the vendee is only $20, yet the vendee has credit for the whole of the tax paid at source and the vendor with $80 interest has credit for no portion of that tax. In view of that fact, the vendor, when disposing of bonds, where tax on the interest is paid at source, must have this feature of the situation in mind. In arriving at the figure for which he would dispose of them, he should recognize the value of (1) the principal, (2) the interest, and (3) the loss arising from inability to take credit for the proportionate share of the tax paid at source.

RULING. Certain bonds contain the privilege of being converted into the stock of the corporation which issued the bonds. If the owner of the bonds exercises his privilege of conversion between interest dates and is allowed accrued interest, he is required to file an ownership certificate covering such accrued interest when it is paid. (C. B. 4, page 234; O. D. 949.)

Ownership certificates to be used by fiduciaries and joint owners.—

REGULATION. When fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. When bonds are owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners. (Art. 374.)

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[40] See *Income Tax Procedure*, 1921, page 250

Use of ownership certificates for tax-free covenant bond interest by personal service corporations.—

RULING. Personal service corporations are to be treated, so far as practicable, on the same basis as partnerships for the purposes of withholding under section 221 (*b*) of the Revenue Act of 1918. Corporations which have received notice from the Income Tax Unit that their returns as personal service corporations have been approved may thereafter and not before issue Form 1000 in collecting interest from bonds or other obligations of a corporation containing a so-called tax free covenant clause in the same manner and to the same extent that partnerships are authorized to use that form. The form should bear the stamped or written notation "approved by the Treasury Department as Personal Service Corporation on (date)." (C. B. 1, page 186; O. D. 339.)

Ownership certificates for payments of registered interest.—

REGULATION. Ownership certificates are required in connection with interest upon registered bonds the same as interest upon any other class of bonds. If ownership certificates are not furnished by the owner of the bonds, such certificates must be prepared by the debtor corporation or its withholding agent. (*a*) If the bonds contain a tax-free covenant clause, ownership certificates must be prepared on Form 1000 for the following classes of bondholders: Citizens or residents of the United States, nonresident alien individuals, partnerships, whether foreign or domestic, foreign corporations having no office or place of business within the United States. (*b*) If the bonds do not contain a tax-free covenant clause, Form 1000 shall be prepared in the case of nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or in case the owner is a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein. If ownership certificates are not filed by a citizen or resident of the United States or a resident partnership in connection with interest payments upon registered bonds not containing a tax-free covenant clause, Form 1001 should be prepared by the debtor corporation or its withholding agent.

Regardless of whether the registered bonds do or do not contain a tax-free covenant clause, no ownership certificate is required in connection with such bonds owned by domestic or resident corporations. (Art. 370; Reg. 45, Art. 369.)

Ownership certificates for foreign items.—

Regulation. When bonds of foreign countries, or bonds or stocks of nonresident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, or by resident partnerships, ownership certificate Form 1001A shall be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent or a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such excepted case the fiscal agent or paying agent is required to withhold a tax of 2 per cent from the interest on such bonds and ownership certificate Form 1000, modified to show the name and address of the fiscal agent or the paying agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case Form 1001A should be filed.[41] (Art. 1077; Reg. 45, Art. 1078.)

Domestic corporations are no longer required to execute form 1001A.

Income payable to a foreign government is not subject to federal income tax, but it is held[42] that it should be reported on line 6 of form 1001A by crossing out the word "corporation" and substituting therefor "foreign government." Apparently this conflicts with article 365.[43]

Rulings. Non-resident alien individuals, partnerships, and corporations not engaged in trade or business within the United States and having no office or place of business therein, should file Form 1001-A properly modified, in connection with interest coupons on bonds of a corporation organized in the United States but which transacts no business in the United States and owns no property therein.

In cases where Form 1000 has been filed by non-resident alien bondholders, the certificate should be stamped as follows before being forwarded to the Commissioner of Internal Revenue, Sorting Division:

Exempt—debtor corporation owns no property and does no business in the United States. (C. B. 1, page 262; O. D. 354.)

Ownership certificates representing interest on bonds owned by nonresident aliens, bearing addresses of domestic bankers in lieu of

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[41] No attempt is made to tax non-resident aliens on income which simply passes through American banks for collection and is not income derived from sources within the United States. See Chapter XXXVI.

[42] C. B. 2, page 191; O. D. 520.

[43] See page 306.

the residences of the aliens, will be accepted. (C. B. 4, page 233; O. D. 908.)

No ownership certificates required for certain foreign dividends.—Following the principle in force under the 1918 law, it is presumed that ownership certificates will not be required in collecting dividends from foreign corporations which are free from normal tax.[44] Ownership certificates will be necessary in the case of dividends from other foreign corporations.[45]

Foreign items presented for collection unaccompanied by ownership certificates.—

Regulation. If the foreign item is an interest coupon detached from bonds containing a tax-free covenant clause, issued by a foreign country or corporation having a paying agent in the United States, a statement and ownership certificate, Form 1000, shall be furnished as provided in article 369.

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, a statement shall be required of the payee, showing the name and address of the payee, the name and address of the debtor organization, the date of the dividend check or the maturity of the interest coupon, the name and address of the person from whom the dividend check or interest coupon was received, and a statement that the owner of the securities is unknown to the payee. The first bank receiving such foreign item shall prepare a certificate of ownership, Form 1001A, crossing out the word "owner" and substituting therefor the word "payee." The first bank shall stamp or write across the face of the certificate "statement furnished," adding the name of the bank. Thereupon the statement and certificate shall be forwarded to the Commissioner as provided in article 1079. (Art. 1078.)

Information as to actual owner.—

Regulation. When the person receiving a payment falling within the provisions of the statute for information at the source is not the actual owner of the income received, the name and address of the actual owner shall be furnished upon demand of the individual, corporation or partnership paying the income, and in de-

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[44] See sections 216 (a) and 234 (a-6).

[45] For former procedure see *Income Tax Procedure*, 1921, page 253.

fault of a compliance with such demand the payee becomes liable to the penalties provided. . . . .[46] (Art. 1080.)

Use of form 1087 (revised) to disclose ownership.—The proper use of this ownership certificate is most conveniently summarized as follows:

Ruling. This ownership certificate [form 1087 (revised)], is designed primarily for the use of a foreign principal to disclose the actual ownership of stock of a domestic corporation registered in the name of his representative in the United States. Unless the disclosure is made to the commissioner on this form, the record owner will be liable for any additional tax on dividends on stock of domestic corporations or resident foreign corporations. In all cases where the actual owner is a nonresident alien individual, and the record owner a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control, and disposal of the dividend income, and must make return for the actual owner, regardless of the amount of income, and pay any surtax found by such return to be due.

When a foreign corporation is the registered owner of stock of a domestic corporation and the actual owner is a nonresident alien, individual or partnership, disclosure of actual ownership should be made on Form 1087 (Revised). This form should be adapted to make disclosure in order that a domestic corporation required to render a return of information as to dividends in accordance with section 254 of the act, may have at its disposal information as to the actual ownership of the stock. . . . (Treasury Bulletin "B", page 27.)

Ownership certificates not required for interest on obligations of the United States and political subdivisions thereof.—

Law. Section 256. . . . . **The provisions of this section . . . . shall not apply to the payment of interest on obligations of the United States.**

Regulation. . . . . No ownership certificates need be filed in the case of interest payments on bonds the income from which is not required to be included in gross income, nor in the case of any obligations of the United States. . . . . (Art. 365; Reg. 45, Art. 365.)

Bonds of the War Finance Corporation are not obligations of the United States.[47] Hence an ownership certificate is re-

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[46] See page 32[illegible].
[47] C. B. 1, page 185; O. D. 284.

quired in collecting interest on such securities. Ownership certificates are not required in case of municipal bonds and such other bonds the interest from which is exempt from tax.

General

Miscellaneous rulings regarding duties of banks.—

RULING. Where a debtor corporation fails to withhold the 2 per cent tax on tax-free-covenant bonds, and the owner has filed Form 1000, there is no obligation on the bank receiving the coupons to withhold the tax, as assessment will be made against the debtor or its withholding agent, based on the tax liability as disclosed by the ownership certificates, Form 1000.

A bank purchasing abroad coupons of bonds issued by domestic corporations will be held prima facie to be the recipient of income. Ownership certificates should therefore be secured from original owners of bonds in order that tax may be withheld as provided by law.

Where a promissory note, signed by a corporation, is left with a bank or trust company for collection, such bank or trust company should not require an ownership certificate to be attached.

Ownership certificates are required to be filed with respect to interest payments upon first-mortgage participation bonds issued by a trust company and secured by a real estate mortgage deposited with the trustee. In cases where coupons of the bonds are not accompanied by ownership certificates, the first bank is required to furnish a certificate. Where no ownership certificates are filed in connection with interest upon such registered bonds, the withholding agent will be required to prepare certificates. (Treasury Bulletin "B," page 31.)

It has been held that in the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates must be filed when collecting interest, in the same manner as if interest coupons were presented for collection.[48]

Use of stamps and facsimile signatures by banks and trust companies.—If proper authorization is obtained from the Commissioner of Internal Revenue, banks and trust companies

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[48] C. B. 2, page 191; O. D. 392.

may use facsimile signatures in executing income tax certificates (substitute or otherwise) issued under their names.[49]

License required for the collection of foreign items.—

LAW. Section 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

REGULATION. Banks or agents collecting foreign items, as defined in article 1076, and required by article 1079 to make returns of information with respect thereto, must obtain a license from the Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors. The license is issued without cost on Form 1010. Foreign items shall not be accepted for collection by any bank or collecting agent so licensed unless properly indorsed or accompanied by proper ownership certificates giving all the information called for by such certificate. (Art. 1111.)

Payer has right to demand name and address of recipient of income.—

LAW. Section 256. . . . . When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income. . . . .

RULING. Official position of person authorized to sign ownership certificates in behalf of corporation and identity of person signing ownership certificates in behalf of partnership required to be disclosed on certificates. (Telegram to the Southern Pacific Company, New York, N. Y., signed by Deputy Commissioner E. H. Batson, and dated June 16, 1921.)

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[49] Either rubber stamps or printed signatures may be used. This concession was made to facilitate collection of coupons by banks. It avoids much delay and inconvenience.

Heavy penalties for failure to furnish information.—The specific penalties for failure or refusal to furnish information were increased in the 1918 law.[50]

REGULATION. A penalty of not more than $1,000 attaches for failure punctually to make a required return, whether of income, withholding or information, or to pay or collect a required tax. If the failure is willful, however, or an attempt is made to defeat or evade the tax, the offender is liable to imprisonment and to a fine of not more than $10,000 and costs. See also the act of July 5, 1884. In addition to these specific penalties *ad valorem* penalties are imposed in various cases. An *ad valorem* penalty is assessed and collected as a part of the tax, while a specific penalty is enforceable only by suit. (Art. 1055; Reg. 45, Art. 1041.)

[50] Section 253. The 1921 law re-enacted this section without any change.

CHAPTER XI

PAYMENT OF TAX AT SOURCE[1]

The framers of the income tax laws of 1913 and 1916 adopted the principle of collection at the source[2] largely on the strength of its success as a feature of British income tax administration. No attempt was made first to test the operation of an income tax in this country by direct collection from the taxpayer. The withholding provisions of these two laws proved burdensome and difficult of efficient administration. Consequently the 1917 law substituted a system of "information at the source" and withholding was completely abolished, excepting only the cases of non-resident aliens and interest on bonds containing a so-called tax-free[3] covenant clause. The withholding provisions of the 1921 law are substantially the same as those of the two laws preceding it.

The subject of withholding of tax at source in connection with non-resident aliens is fully discussed in Chapter XXXVI.

So far as citizens or residents of the United States are concerned there is now no withholding or payment of tax at the source, except in the case of tax-free covenant bonds. Nev-

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[1] As the subject of "Information at the Source" has been treated in Chapter X, "Non-Resident Aliens" in Chapter XXXVI, "Monthly and Annual Returns" in Chapter III, all questions as to forms of ownership and information certificates required in the various cases and the withholding of income paid to non-resident aliens and monthly and annual returns required have been omitted from this chapter.

[2] This is variously called "collection at the source," "deduction at the source," "withholding at the source," and "stoppage at the source." Collection at the source was early instituted in British income tax administration to prevent evasion of the law. In the 1920 *Report of the Royal Commission on the Income Tax,* the opinion has been emphatically expressed that retention of deduction at the source is necessary to the efficient administration of the revenue. At least 70 per cent of the present British income tax is collected at the source. The Commission has also concluded: "We are not satisfied that any system of 'information at the source' would be a practical and efficient substitute for the present system, and it would be a source of trouble and irritation to the community in general."

[3] This term should not be confused with "tax-exempt," which means freedom from taxation—state, local or federal, or all three.

ertheless, there has been considerable agitation for its complete abolition and this withholding feature of the law would doubtless have been abolished if it had not been for the opposition of bond owners and investment banking houses. After the enactment of the 1913 law many bonds were issued which contained tax-free covenants whereby the debtor corporations agreed to pay interest in full without deducting the amount of tax required to be withheld at the source. Bonds having such covenants commanded a somewhat higher price than those not having such agreements. Those who had purchased bonds for this privilege were naturally opposed to any modification of the law which would abolish it. To meet these objections the 1917, 1918, and 1921 laws provided for restricted withholding in the case of tax-free covenant bond interest.

What is a "tax-free covenant"?[4]—The law defines a tax-free covenant as follows:

LAW. Section 221.[5] . . . . **(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the title imposed by this title upon the obligor, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.**[6] . . . .

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[4] Tax-free covenants are frequently not limited to federal taxes, but include any state, county or local taxes or impositions which the obligor may be required or permitted to deduct or retain under present or future laws.

[5] Subsection (a) refers only to non-resident alien individuals or partnerships. (See Chapter XXXVI.)

[6] **[Former Procedure]** Under the 1913 law withholding was required in the case of interest on domestic and foreign bonds and dividends of foreign corporations regardless of amount, and on payments of interest, rent, salaries, wages, premiums, annuities, compensations, remuneration, emoluments or other fixed or determinable gains, profits and income amounting to $3,000 or over in any taxable year. Exemption from the withholding provisions of the act could be obtained to the amount of the personal exemption, by filing a certificate with the withholding agent, and a further exemption was permitted by filing a statement of the deductions to which the taxpayer was entitled.

Under the 1916 act the withholding provisions were similar except that the rate was increased from 1 to 2 per cent. However, under

By Treasury interpretation bonds issued under a trust deed containing a tax-free covenant are treated as if they themselves contained such a covenant. It is also held:

RULING. Where neither bonds nor the trust deeds given by the obligor to secure them contain a tax-free covenant, supplemental agreements executed by the obligor corporation and the trustee containing a tax-free covenant and which modify the original trust deeds to that extent are of the same effect from the date of their proper execution as if they had been part of the original deeds of trust, and the bonds from such date are subject to the provisions of section 221(b) of the Revenue Act of 1918, provided proper authority exists for the modification of the trust deeds in this manner. The authority must be contained in the original trust deeds or actually secured from the bondholders. (C. B. 2, page 187; O. D. 414.)

Amount of tax to be withheld by obligor corporation.—

LAW. Section 221. . . . . (b) . . . . the obligee shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods. . . . .

"Withholding agent" defined.—

LAW. Section 200. . . . . (3) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237; . . . .

The sections referred to in the foregoing relate to nonresident alien individuals or partnerships and foreign corporations, as well as to domestic corporations paying interest on bonds having a tax-free covenant.

The legal theory of "deduction."—The tax-free covenant clause in bonds has long been a prolific source of misunder-

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the 1917 law withholding was abolished except in the case of nonresident aliens and interest on tax-free bonds, and section 1212 of that act provided for refunding all tax that had been withheld during 1917 except such as had been withheld on tax-free bonds.

Withholding agents did not in all cases promptly release the amounts in their hands, although the law was so clear that no time should have been lost after October 3, 1917, in returning the funds. If withholding agents did not have in their possession the information regarding the legal owner of the bonds to whom repayment was due, they were directed to communicate with the bank through which collection was made, secure the name of the payees and promptly refund the amounts due. (T. D. 2635, January 24, 1918.)

standing and confusion to the average bondholder, notwithstanding the effort of investment houses to clarify its meaning. Perhaps such covenants should be omitted from future issues to avoid the inherent difficulties which attend their use.

Confusion arises chiefly from the necessarily involved legal phraseology of such covenants and the legal fiction of "deduction." The legal fiction is that a tax-free covenant requires the debtor corporation actually to deduct 2 per cent from the amount of the coupon, pay this sum to the government, and then pay the bondholder 98 per cent of his coupon *plus* an additional 2 per cent, if the corporation has agreed to reimburse to that extent. Such is the legal fiction of deduction. In practice the corporation pays the coupon in full and *in addition* pays on behalf of the bondholder to the government a tax equivalent to 2 per cent of the amount of the coupon. (See discussion of *Massey v. Lederer* in Chapter XIX.)

Under some tax-free covenants the debtor corporation only agrees to reimburse the bondholder up to 1 per cent of the amount of the coupon. In this case the theory is that 2 per cent is deducted from the coupon and the bondholder is paid 98 per cent of the coupon *plus* a reimbursement of 1 per cent. Practically, the bondholder gets 99 per cent of his coupon and the corporation pays 2 per cent to the government for him.

Limitation of the debtor corporation's liability.—The contention that corporations having tax-free covenants in their bonds contracted to pay the full normal income tax is now mainly of academic interest.

When a corporation has specifically agreed to pay the normal income taxes assessed against the owners of its bonds on the income accruing therefrom, it should be held strictly to such agreement; but obviously such an agreement must be reasonably, if not strictly, construed. If federal income taxes are the only ones mentioned, it cannot be contended that state income taxes are to be paid. If the normal tax rate

in force when the bonds were issued was 1 per cent and if the rate is raised to 2 per cent or 12 per cent, the corporation must pay the increased rate. But if 2 per cent is the "normal" rate and a law specifies that in addition to the "normal" tax of 2 per cent an "additional" tax of 4 per cent is imposed, the corporation should not pay more than the 2 per cent normal tax.[7]

If a corporation has not agreed to pay the bondholder's income tax, but has agreed merely to pay such taxes as it is required to *withhold,* there is no obligation on its part, moral or legal, to pay any tax, normal or surtax, income or property, federal or state, which may be legally assessed against the recipients of the income, *unless* the corporation is required by the government to withhold the tax.

Corporations are ordinarily obligated *to reimburse* bondholders *only for the amount which they are required to deduct,* and in some cases this reimbursement is expressly limited by contract to a sum *less* than the amount theoretically deducted (e. g., 1 per cent). Even though the present normal tax is 8 per cent, *it is lawful to withhold only to the extent of 2 per cent.*

Since the imposition of a high normal tax there has been a tendency to state the actual percentage of tax for which the corporation will make reimbursement. Among such provisions are: "Both principal and interest payable in full without deduction for any federal normal income tax . . . . not in excess of 2 per cent" and "both principal and interest payable in full without deduction for any federal normal income tax . . . . up to 4 per cent." The first clause limits the present and future liability to reimburse to 2 per cent. The second clause limits such future liability to 4 per cent. In other words, if under a future law 6 per cent were the lawful deduction, reimbursement would be made to the extent of 2 per

[7] **[Former Procedure]** Normal taxes imposed by the Act of October 3, 1917, were in addition to those imposed by the Act of September 8, 1916. The Revenue Act of 1918 contained no provision of this kind, prior laws being thereby repealed. This, however, apparently does not constitute an argument for full payment of normal tax.

cent under the first clause or 4 per cent under the second. This 4 per cent limitation should not be construed to render corporations liable to 4 per cent under the present law, because 2 per cent is the maximum possible lawful deduction in the case of a bond containing a tax-free covenant clause.

From whom tax is withheld.—The law provides that in making payments of interest on tax-free covenant bonds, the obligor shall deduct and withhold a tax equivalent to 2 per cent of the coupon.

LAW. Section 221. . . . . (b) . . . . **whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership:** *Provided*, **That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust or other obligations, the owners of which are not known to the withholding agent. . . . .**

LAW. Section 237. **That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section:** *Provided*, **That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.**

The Treasury's interpretation follows:

REGULATION. . . . . (*c*) of a tax of 2 per cent in the case of interest payable to an individual or a partnership, whether resident or nonresident, or to a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, upon bonds or other obligations of domestic or resident foreign corporations containing a so-called tax-free covenant clause. . . . . A foreign corporation having a fiscal agent or paying agent in this country is required to withhold a tax of 2 per cent upon the interest on its tax-free covenant bonds. . . . . (Art. 361.)

RULING. "Withholding at the highest applicable rate" as provided in article 361 of Regulations 45, in the case of interest on bonds or other securities where the owner is unknown to the withholding

agent is interpreted to mean the highest rate of tax applicable under section 221 of the Revenue Act of 1918, viz., 2 per cent in the case of tax-free bonds and 8 per cent in the case of other fixed or determinable annual or periodical income.[8] (C. B. 2, page 188; O. D. 518.)

When tax withheld is paid by withholding agent.—

LAW. Section 221. . . . . (c) **Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United States government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section. . . .**

When no liability of withholding agent for collecting of tax at source.—

LAW. Section 221. . . . . (c) **If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be recollected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.**

No withholding against domestic and resident foreign corporations.—The law does not require withholding from interest on tax-free covenant bonds paid to a domestic corporation or to a foreign corporation having an office or place of business in the United States and engaged in a trade or business therein.

Under the 1918 law personal service corporations were taxed like partnerships, as far as was practicable. Consequently, under that law it was proper for debtors constructively

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[8] It appears that the highest applicable rate of tax in the case of interest on bonds which do not contain the tax-free covenant clause would be 12½ per cent after 1921, or the rate of withholding on non-resident alien corporations. It seems that for its own protection the government would desire an additional withholding of 10½ per cent in case of interest on tax-free obligations.

to withhold tax in making payment of tax-free covenant bond interest.[9] This is the only exception to the rule that there is no withholding against a domestic corporation.

If the taxation of the stockholders of personal service corporations is held to be invalid, it is not probable that any readjustments for tax-free covenant interest under the provisions of section 1332 will follow. Personal service corporations disappear as taxable entities after December 31, 1921. Hence, after that date, debtors will not withhold against such corporations. The tax-free covenant no longer has any advantage for personal service corporations.

As a rule, in the case of payments of tax-free covenant bond interest to domestic or resident corporations,[10] no payment is made to the government on their behalf; hence the tax-free covenant is of no value to such holders. This feature of the law makes the tax-free covenant less costly to the issuing corporation, since large blocks of bonds are sold to banks, insurance companies, and other corporations.

Apparently, in a few isolated cases, debtor corporations have, inadvertently or otherwise, paid tax on behalf of corporations owning their bonds. Under the 1918 regulations, such payment was allowed as a credit against an owner's normal tax, upon proof of payment.[11]

Section 221 (b) of the 1921 law provides that the Commissioner may authorize the tax of 2 per cent to be deducted from the interest on tax-free covenant bonds the owners of which are not known to the withholding agent. Under the regulation issued on this point,[12] it would appear to be possible for domestic corporations to obtain the benefit of having the tax paid for them by concealing their identity. This, however, would be a palpable evasion of the law, and is neither recommended nor suggested. Under the law there is no

[9] Art. 365.

[10] Excepting personal service corporations during years 1918 to 1921, inclusive.

[11] See *Income Tax Procedure*, 1920, page 246.

[12] See page 327.

other way in which domestic corporations can get the benefit of tax-free covenants in bonds owned by them.

Withholding obligation on bond interest paid in years after the interest became due.—

RULING. . . . . Bond interest represents income to taxpayer when due and payable in accordance with article 54, Regulations 45. No tax required to be withheld from interest upon bonds due prior to March 1, 1913, but paid subsequent to that date. Interest due on and after March 1, 1913, subject to withholding at rates in force at time of payment but in case excess tax is withheld and paid to government claim for refund on form 46 will be considered. (Telegram to A. Iselin & Co., New York, N. Y., signed by P. S. Talbert, Acting Assistant to the Commissioner, and dated September 8, 1919.)

From the above it would appear that no withholding is necessary by a debtor corporation in the case of coupons from bonds containing a tax-free covenant clause now presented but due prior to March 1, 1913; but on any coupons maturing subsequent to that date, withholding must be made at the rate in existence at the time of payment. The date of maturity does not determine the rate of withholding. Of course, if an excessive tax is withheld and paid, the bondholder may secure relief by filing a claim for refund.

Withholding at the source of interest on bonds having no tax-free covenant.—

The government has taken the position that corporations whose securities do not contain a tax-free covenant shall not be permitted to pay the tax except under supplemental agreements.

RULING. Your telegram May 29. Bonds without tax-free covenant not permitted to be considered tax-free bonds at option of issuing corporations. Corporation only allowed to withhold tax at rate of 8 and 10 per cent from non-resident alien individuals and non-resident alien corporations respectively. Corporation prohibited from paying tax on interest derived from such bonds when owned by citizens or residents of United States. (Telegram to the Farmers' Loan & Trust Company, New York, N. Y., signed by Commissioner Daniel C. Roper, and dated June 2, 1919.)

Exemption from withholding.—Under the law the debtor corporation or its paying agent is required to withhold a tax of 2 per cent on tax-free covenant bond interest paid to individual citizens or residents *who do not claim exemption,* and in the case of resident partnerships. (Withholding on account of non-resident alien individuals, foreign partnerships and corporations is discussed in Chapter XXXVI.)

The statute provides that exemption from withholding may be claimed in the following manner:

LAW. Section 221. . . . (b) . . . . **Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g), section 217.** . . . . [Section 217 gives the Commissioner discretion in allowing non-resident alien individuals to claim exemption by means of certificates of ownership.]

This provision of the law and the use of ownership certificates in its administration are responsible for much of the bondholder's confusion regarding tax-free covenants. In the case of tax-free covenant bonds interest is paid in full regardless of whether exemption is or is not claimed. If exemption is claimed on such coupons, the taxpayer merely serves notice on the debtor corporation that his income is too small to be subject to tax and therefore nothing should be paid to the government on his behalf. If exemption is not claimed, a tax of 2 per cent of the amount of the coupon is paid to the government by the obligor.

Who should claim exemption from withholding?—Individual citizens or residents are privileged to claim exemption from withholding, but partners may not claim such exemption. A resident alien is required, in claiming such exemption, to file in addition a certificate of residence (form 1078, revised) with the withholding agent.

Individual citizens or residents should claim exemption, if the total amount of net taxable income does not exceed their personal exemptions, i.e., $1,000 for a single person, $2,000 or $2,500 for a married person, plus $400 for each dependent.[13] By filing such a claim the individual relieves the debtor corporation from paying a tax not lawfully due.

The debtor corporation's liability under a tax-free covenant covers only the portion of *normal tax* deductible at the source. If, therefore, a taxpayer is subject *only to surtax,* because his lawful deductions exceed the amount of income, if any, subject to normal tax, he should relieve the debtor corporation from making payment to the government in his behalf by filing a claim for exemption in collecting tax-free covenant bond interest. The situation is analogous to the case mentioned in the preceding paragraph.

If an individual who has not claimed exemption at the time of collecting the interest afterwards desires to claim exemption, he may file in writing with the paying agent, at any time prior to February 1 of the succeeding year, his notice claiming exemption. Form 1001 may be used for such notice.

Similarly, an individual who has claimed exemption and subsequently desires not to claim exemption must file notice in writing (form 1000) with the paying agent on or before February 1.

Tax paid on tax-free covenant bond interest considered income.[14]—The Treasury Department, in 1919, ruled that any tax paid pursuant to a tax-free covenant clause on behalf of a taxpayer should be considered in the nature of additional interest and should be reported by the taxpayer in his return. This ruling was a source of great irritation to the investing public and aroused many protests. The 1921 law, under section 234 (a-3), specifically provides that taxes paid under

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[13] See page 31 *et seq* for discussion of personal exemption.
[14] For discussion, see Chapter XIX.

tax-free covenants shall not be included in the gross income of the taxpayer.

Tax paid on tax-free covenant bond interest not deductible by corporation.[15]—Under section 234 (a-3) of the law, the debtor corporation is not allowed to make deduction for federal taxes so paid under the heading of either interest or taxes.

Credit for taxes paid on tax-free covenant bond interest.—Taxpayers are allowed to credit their total normal and surtaxes with the amount of any tax paid for them at the source by a debtor corporation pursuant to a tax-free covenant clause.[16]

[15] For discussion, see Chapter XIX.
[16] Section 221 (d).

PART II

INCOME

CHAPTER XII

CREDITS AND EXEMPT INCOME

In addition to the deductions from gross income which are fully discussed in Chapters XXV to XXXIV, the tax laws have provided other means of reducing tax liability. Taxpayers in receipt of large incomes are chiefly interested in the various classes of wholly exempt income; taxpayers whose incomes are less than $5,000 are chiefly interested in the specific exemptions. There is a vast difference between deductions and credits; the former affect surtaxes as well as the normal tax; credits for specific exemptions, dividends and the like reduce only the normal tax. Credits and exempt income are discussed at this point because the net effect of each is to reduce the amount of taxes which would be due if taxpayers merely reported their gross income. It is less confusing to dispose of these possibilities in one chapter.

Income Exempt from Normal Tax Only—"Credits"

The law imposes a normal tax of 8 per cent[1] on the total net income of individuals, and graduated surtaxes upon the larger incomes. It imposes a flat 10 per cent rate (no surtaxes[2]) upon the income of corporations, which is raised to 12½ per cent after December 31, 1921. Partnerships are not taxed as independent units, the partners instead being taxed upon their respective shares of the profits whether or not distributed.[3] Certain individual income[4] is exempt from the normal tax, but is nevertheless subject to the surtax rates, the

[1] Reduced to 4 per cent on the first $4,000. See Chapter VII.

[2] Up to December 31, 1921, there was the excess profits tax in addition. See *Excess Profits Tax Procedure*, 1921.

[3] For a full statement, including a discussion of personal service corporations, see Chapter XXIV.

[4] Certain dividends, certain interest, and the personal exemptions.

adjustment being made by "crediting" (section 216) these items of income for purposes of the normal tax only. Even in the case of corporations, where no surtax rates apply, there are certain items[5] which, in accordance with the practice in the case of individuals, are entered as "credits" (section 236) rather than as deductions, the effect being to make the term "net income" include these items for excess profits tax purposes. In this chapter the exemptions and credits alluded to are discussed.

The personal exemptions: wife and dependents.—

LAW. Section 216. . . . . **(c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500, unless the aggregate net income of such husband and wife is in excess of $5,000, in which case the amount of such personal exemption shall be $2,000. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them. In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000;**[6]

(d) $400[7] **for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective. . . . .**

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[5] The specific exemption of $2,000, on incomes of $25,000 or less, and of certain interest, excess and war profits taxes.

[6] **[Former Procedure]** The 1913 law [section II (C)] and the 1916 law [section 7 (a)] permitted the deduction "for the purpose of the normal tax only" and made the exemption $3,000, plus $1,000 additional if the person making the return were married with husband or wife living with her or him. The normal tax, which was 1 per cent under the 1913 law, was made 2 per cent in 1916. The 1917 law allowed this arrangement to remain in force, but added what in effect was a second and distinct income tax with an additional normal rate of 2 per cent. For the purpose of this new 2 per cent tax the exemptions of $3,000 and $4,000 provided in the 1916 law were changed to $1,000 and $2,000 (1917 law, Title I, section 3). Consequently there were two sets of exemptions in 1917, one for each normal tax of 2 per cent. The 1918 law provided for one set of exemptions of $1,000 and $2,000 [1918 law, section 216 (c)].

[7] This is an increase of $200 in the exemption allowed for each dependent under the 1918 law.

The addition in the 1921 law of $500 to the personal exemption for the head of a family or a married person living with a spouse, is extended only to those whose incomes do not exceed $5,000. The limitation of the higher exemption is explained in the following example:

EXAMPLE

Two taxpayers, A and B, married, no children, with net taxable incomes of $5,010 and $5,030 respectively.

The computation of A's tax is made in the following manner:

(1) Net income	$5,010.00	
Personal exemption	2,500.00	
Amount subject to tax	$2,510.00	
Tax at 4%		$100.40
(2) Net income	$5,010.00	
Personal exemption	2,000.00	
Amount subject to tax	$3,010.00	
Tax at 4%		120.40
Excess of computation (2) over (1)		$20.00

Since this amount of $20 is greater than the excess of the net income over $5,000, viz., $10, and since the tax under (2) must not be greater than the tax under (1) by more than the excess of $5,010 over $5,000, i. e., $10, the total tax due by A is, therefore, $100.40 plus $10=$110.40, instead of $120.40.

In the case of B the computations are:

(1) Net income	$5,030.00	
Personal exemption	2,500.00	
Amount subject to tax	$2,530.00	
Tax at 4%		$101.20
(2) Net income	$5,030.00	
Personal exemption	2,000.00	
Amount subject to tax	$3,030.00	
Tax at 4%		121.20
Excess of computation (2) over (1)		$ 20.00

In this instance the reduced exemption does not increase the tax beyond the amount of income over $5,000, viz., $30. The total tax due by B is, therefore, $121.20.

It will be found that the benefit of the provision ceases in case of taxable net incomes over $5,020. The tax on net incomes, of other than single individuals, at and below that figure, but in excess of $5,000, will be computed on the same basis as A above.

Test of dependency.—

Regulation. A taxpayer receives a credit of $400[8] for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (*a*) under eighteen or (*b*) incapable of self-support because defective. The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit. (Art. 304.)

"Head of a family" defined.—

Regulation. A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. In the absence of continuous actual residence together, whether or not a person with dependent relatives is a head of a family within the meaning of the statute must depend on the character of the separation. If a father is absent on business or at war, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support. A resident alien with children abroad is not thereby entitled to credit as the head of a family. (Art. 302.)

There are slight verbal changes in this article, as compared with article 302, Regulations 45.

The foregoing regulation does not impair the right of a parent to claim the $400 for each dependent irrespective of

[8] The credit for dependents under the 1916, 1917 and 1918 laws was $200.

the nationality or place of residence of the dependents. The requirement of residence in "one household" has been abandoned.[9] It had no justification under the law.[10]

When "without necessity the dependent continuously makes his home elsewhere," it may be reasonable to hold that the taxpayer is not to be considered the head of a family. If, however, a resident alien has children abroad "with" necessity, it would seem that, in addition to the credit of $400 for each dependent, the resident alien should be classed as the head of a family because every resident alien individual is subject to the income tax, even though his income is derived wholly from sources outside the United States.[11]

If a taxpayer can qualify as the head of a family under the definition formulated above, he can claim as personal exemption the full $2,500, or $2,000, as the case may be, even though he be not married. On the other hand, it is no longer necessary that he be the head of a family to claim the $400 for each dependent, provided he supplies the "chief support" of such dependent. Practically every unmarried person who is the chief supporter of a dependent should be able to qualify as a head of a family and avail himself of the additional personal exemption as well as the $400 deduction. A widow or a widower supporting minor children is clearly a "head of a family." A child acting as the main support of a dependent parent or a minor brother or sister is entitled to the additional exemption, plus the $400 exemption for each minor child or dependent person mentally or physically defective. An uncle upon whom nephews and nieces are dependent is entitled to the full exemption for those under eighteen years of age.[12] It has been held that a child over eighteen years of age, away at school, with an income in excess of $1,000 a year (who filed an income tax return claiming exemption of $1,000), but whose income was insufficient to pay half the cost

[9] C. B. 3, page 194; O. D. 665.

[10] *Income Tax Procedure*, 1920, pages 31 and 32.

[11] Section 210.

[12] C. B. 4, page 215; A. R. R. 551.

of its support, is "dependent" on its mother (a widow), who is therefore entitled to exemption as the head of a family.[13] A widower with a daughter over eighteen years of age who receives nominal income from other sources and is neither physically nor mentally incapable of self-support, is head of a family.[14]

In cases where several persons combine to contribute to the joint support of several dependents, it may be desirable to allocate their contributions to particular persons in the group of dependents to the extent of making the taxpayers clearly the main supporters of certain individuals. By so doing they provide a basis for exemption claims which otherwise could not be allowed. This principle has been maintained in a ruling to the effect that, where a husband and wife both contribute to the support of a dependent, the credit must be taken by the one contributing the chief support and may not be divided between them.[15]

Where, in a family group, one claims the exemption applicable to the head of the family, the income of minors who are dependent upon him should be included in his return, because the law to this extent contemplates the computation of the tax upon the family as a unit. The following ruling under the 1918 law bears on this point.

RULING. A father has two sons, seventeen and twenty years of age, respectively. During 1919, each son earned in excess of $1,000, but both were dependent upon the father since he appropriated their entire earnings.

In view of the fact that both sons were minors, and had not been emancipated, and their earnings were appropriated by the father, the entire amount of such earnings, together with the father's income from all other sources, must be reported in the father's return for 1919. The credit of $200 for dependents is applicable only to the son under 18 years of age. (C. B. 4, page 214; O. D. 797.)

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[13] C. B. 2, page 159; O. D. 474; also Bulletin C. B. 4, page 214; O. D. 775.

[14] C. B. 2, page 159; O. D. 422.

[15] C. B. 4, page 214; O. D. 776.

The father was not well advised. He should emancipate the sons, charge them board and have them make tax returns.

MINORS NOT EXEMPT.—A minor as such is not exempt. If he has a substantial income a separate return should be made for him and the $1,000 exemption should be claimed.[16]

RULING. Where a father has made a bona fide and absolute gift of property to his minor child, the income therefrom need not be included in the father's return of gross income for the purpose of normal tax and surtax, even though the father administers the property and collects the income for the child. In such a transaction there is no presumption that the gift is or is not bona fide, but the burden should be upon the father in each case to show that it is an absolute gift to the child. (C. B. 3, page 116; Sol. Op. 14.)

STATUS AT END OF YEAR DETERMINES EXEMPTION.—The status of the taxpayer on the last day of his taxable year is the significant factor in establishing his right to the personal exemption.

LAW. Section 216. . . . . **(f) The credits allowed by subdivisions (c), (d), and (e),[17] of this section shall be determined by the status of the taxpayer on the last day of the period for which the return of income is made; but in the case of an individual who dies during the taxable year, such credits shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the period for which such survivor makes return of income.**

The inclusion of the above section is new in the present law. It is, however, based on a regulation issued under the Revenue Act of 1918.[18]

WHAT CONSTITUTES "LIVING WITH HUSBAND OR WIFE"?—

REGULATION. In the case of a married man or married woman the joint exemption replaces the individual exemption only if the man lives with his wife or the woman lives with her husband. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within

[16] See page 84.
[17] See Chapter VII, page 155.
[18] Reg. 45, Art. 305.

the meaning of the statute must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together for the purpose of the statute, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption. (Art. 303.)

RULING. The taxpayer's wife was granted an annulment of the marriage with him by a court composed of three workmen, known as the People's Commission, under the Soviet régime. She later married a Russian subject. This marriage was under Soviet auspices. On or about August —, 1920, her marriage with the Russian was resolemnized by a clergyman.

Irrespective of their personal relations the above facts do not indicate that the separation was of a temporary character or that it was unavoidable. It is held that the taxpayer did not have on December 31, 1920, the status of a married man living with his wife. (B Digest 49-21-1960; O. D. 1124.)

The fact that a husband has been declared mentally incompetent and that his consequent confinement in an institution may be indefinite has no effect on the joint personal exemption.[19]

PERSONAL EXEMPTION VALID FOR NORMAL TAX ONLY.—In computing the surtax, the personal exemption may not be deducted from the net income.[20] Therefore, if a head of a family has more than seven dependents for 1921 and more than nine for subsequent years, or if all of a taxpayer's income is from dividends or from a large amount of Liberty bonds, it is possible for him to be subject to a surtax while exempt from the normal tax.

PERSONAL EXEMPTIONS OF RESIDENT ALIENS.[21]—An alien resident in the United States is in almost all respects treated

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[19] C. B. 3, page 130; O. D. 603.
[20] See section 216, "For purposes of normal tax only. . . . ."
[21] For exemptions of non-resident aliens, see Chapter XXXVI.

exactly as a citizen. He is permitted to take advantage of the personal exemptions in the usual manner.

RULING. An alien residing in the United States permanently, with wife and children residing abroad, is entitled to a personal exemption of only one thousand dollars since he is not living with his wife, but is entitled to a two hundred dollar credit for each child, provided such child is dependent upon and receives its chief support from him and is under eighteen or incapable of self-support because defective. (C. B. 3, page 195; O. D. 640.)

PERSONAL EXEMPTIONS OF WARDS, BENEFICIARIES AND ESTATES.—Wards and other beneficiaries receiving their income from estates are entitled to claim exemption according to their status, and the guardian or trustee when making returns is allowed to deduct this personal exemption from the amount of income derived from the property of which he has charge in favor of each ward or beneficiary who has not claimed a personal exemption independently or through another trustee [section 219 (d)]. Where the estate is subject to a tax by reason of income received by it but not distributed during the year, a deduction of $1,000 only (no deductions for dependents) is allowed in computing the tax upon the estate [section 219 (c)]. This is the only instance in which the personal exemption may be claimed by anyone other than the individual taxpayer.[22]

REGULATION. (a) An estate or trust taxed to the fiduciary is allowed the same credits against net income as a single person, including a personal exemption of $1,000, but no credit for dependents. . . . . (b) . . . . Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. . . . . (Art. 346.)

For a detailed discussion of the subject of fiduciaries, see Chapter XXXVII.

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[22] [Former Procedure] Prior to the enactment of the 1917 law this exemption (but $3,000 in amount) applied to all estates [section 7 (a)], but as amended by that law the exemption was limited to citizens or residents of the United States, excluding non-resident aliens. The 1918 law again permitted the exemptions in the case of all estates, domestic and foreign.

Specific Credit to Corporations

Corporations whose net income does not exceed $25,000 are entitled to a specific credit of $2,000. This provision is effective from January 1, 1921.

LAW. Section 236. **That for the purpose only of the tax imposed by section 230 [income tax] there shall be allowed the following credits: . . . .**

(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000;[23] . . . .

This provision, which corresponds closely to the specific exemption from normal tax extended to individuals, has as one of its effects the entire elimination of the payment of any tax by a domestic corporation whose net income is less than $2,000. In case a consolidated return is filed for several corporations, only one $2,000 specific credit is allowed, and that only if the consolidated net income does not exceed $25,000.[24] A further analogy to the specific exemption allowed individuals appears in the limitation of the credit. Only corporations with net incomes of $25,000 or less reap the benefit of this provision. The application of the credit to corporations whose net income is but little in excess of the $25,000 is illustrated by the following computations:

EXAMPLE I

CORPORATION A WITH NET INCOME IN 1921 (AFTER DEDUCTING THE CREDIT FOR EXCESS PROFITS TAXES) OF $25,100

(a) The tax, without the specific credit, at 10%		$2,510.00
(b) Net income of	$25,100	
Less: Credit	2,000	
Tax at 10% on	$23,100	2,310.00
Excess of (a) over (b)		$ 200.00

[23] **[Former Procedure]** Under the 1909 law corporations received a $5,000 exemption. Under the 1913, 1916 and 1917 laws corporations did not receive any specific exemption. The 1918 law reinstated a specific exemption (for income tax purposes only) to the extent of $2,000.

[24] For a discussion of the credit allowed corporations for excess profits taxes imposed, see Chapter V, *Excess Profits Tax Procedure*, 1921, and Appendix A in this book.

As the limitation imposed by the section precludes the tax computed under (a), \$2,510, exceeding the tax computed under (b), \$2,310 (an excess of \$200), by more than the income in excess of \$25,000 (\$100), the actual tax in the case of corporation A would be: \$2,310+\$100=\$2,410.

EXAMPLE II

CORPORATION B WITH NET INCOME IN 1921 (AFTER DEDUCTING THE CREDIT FOR EXCESS PROFITS TAX) OF \$25,300

(a) The tax, without the specific credit, at 10%		\$2,530.00
(b) Net income of	\$25,300.00	
Less: Credit	2,000.00	
Tax at 10% on	\$23,300.00	2,330.00
Excess of (a) over (b)		\$ 200.00

In this example the excess of (a) over (b), \$200, is not more than the excess of the net income over \$25,000, \$300; the actual tax, therefore, of corporation B remains as computed without the specific credit, i. e., \$2,530.

The same examples would hold good for the taxable year 1922, except that the rate of taxation is raised to 12½ per cent. The repeal of the excess profits tax will also mean that the whole of the taxable net income will be subject to the income tax, i. e., there will be no credit for excess profits tax. The dividing line below and above which the specific credit of \$2,000 is effective, or otherwise, is \$25,200 for 1921 and \$25,250 for 1922.

Dividends Which Are Exempt from Normal Tax

Dividends of the classes referred to in section 216 below are exempt from normal tax in the hands of recipients.

LAW. Section 216. **That for the purpose of the normal tax only there shall be allowed the following credits:**

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262,[25] or (2) from a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has

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[25] Refers to limitation of gross income of certain corporations to that derived from sources within the United States. See Chapter XXXVI.

been in existence) was derived from sources within the United States as determined under the provision of section 217;[26] . . . .

The above credit applies to individuals and its effect is to exempt dividends from the normal tax even though the paying corporations are exempt from tax.[27] In the case of corporations substantially the same language is used in a clause[28] included among the deductions, which makes dividends received from other corporations non-taxable. The passage of the corresponding section of the 1918 act eliminated completely the long-standing discrimination against corporations which own stocks in other corporations.[29]

Prior to 1921 the situation regarding dividends received by citizens or residents from foreign corporations was anomalous. As long as the distributing corporation was "subject to tax" in the United States, quite independent of the fact that it might actually pay no tax in this country, dividends from such corporations were exempt from normal taxes. The position is now clarified to the extent that more than one-half of the in-

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[26] See Chapter XXXVI.

[27] **[Former Procedure]** Under the 1918 law the exemption was limited to dividends received from corporations taxable under that law.

Dividends received by the holders of the preferred stock of a corporation, all of the common stock being owned by a town, the corporation furnishing water, power, light and heat to the town, are not exempt from normal tax. (C. B. 1, page 93; O. D. 328.)

[28] Section 234 (a-6).

[29] **[Former Procedure]** Under the 1913 and 1916 laws corporations were not permitted to deduct dividends received from other corporations. The 1917 law, which levied an additional 4 per cent tax on corporations, exempted dividends received by corporations from this rate, but not from the 2 per cent rate of the 1916 law, which continued in force, except as to dividends out of earnings realized during 1913, 1914 and 1915, which were taxable at 1 per cent (see Chapter VII). The exemption was granted in the form of a "credit" (1917 law, war income tax, section 4). The permission given corporations by the 1918 law to deduct dividends has the effect of automatically relieving such dividends from the excess profits tax. This was accomplished by special provision in 1917. A consolidated return in 1917 was permitted only for the purpose of the excess profits tax. For income tax purposes separate returns were required for each corporation, imposing upon each corporation the 2 per cent rate on dividends under the 1916 law which was still in effect. In making a consolidated return for a fiscal year beginning in 1917 and ending in 1918, when the computation was made to determine the tax applicable to the portion of the year falling in 1918, all dividends were deducted in determining net income.

come of the foreign corporation must have accrued from sources within the United States.

Foreign corporations doing sufficient business in the United States should notify their stockholders regarding the right of credit. When stockholders do not receive a notice the credit should not be claimed. If stockholders have reason to think that they should receive the credit, but have received no notice concerning it from the corporation, they should, of course, ask the corporation for information regarding it.

It should be noted that Porto Rico and the Philippine Islands are not included in the term "United States" for the purposes of the statute. Dividends received from corporations taxed in those countries, but having no income from sources within the United States, are not allowed as credits against net income of individuals or gross income of corporations (article 1131).

Dividends from personal service corporations which were specifically alluded to in this section of the 1918 law are not included in the present section.[30] The status of these corporations is that of ordinary domestic corporations, after December 31, 1921.

A full discussion of the situation created by the 1921 law in connection with dividends and distributive profits of personal service corporations, is given in Chapter XXIV.

Dividends of a personal service corporation paid on or after January 1, 1918, out of earnings accumulated prior to January 1, 1918, are exempt from the normal tax and returnable the same as dividends paid by ordinary corporations. Dividends of a personal service corporation paid on or after January 1, 1918, and prior to January 1, 1922, out of earnings

[30] **[Former Procedure]** Dividends paid by a personal service corporation from earnings accumulated prior to January 1, 1918, are exempt from the normal tax. Dividends paid by a personal service corporation between January 1 and March 1, 1918 (both inclusive), are deemed to have been paid from the earnings of 1917 [section 201 (e)], but were taxable at the rates of surtax in force in the year in which received, viz., 1918. The result is that as to the dividends received in these two months the stockholders of a personal service corporation were on the same basis as the stockholders of any other corporation.

accumulated after January 1, 1918, have not been subject to any tax at all in the hands of the corporation. The entire net income of the corporation has been taxed to the individual stockholders for both normal and surtaxes, whether or not distributed; hence dividends, as such, when received are not taxable and need not be reported at all. If the distributee is not a stockholder at the end of the year, an accounting must be made to determine the tax liability for the taxable year. [See section 218 (d).]

Interest which is exempt from normal tax.—

LAW. Section 216. **That for the purpose of the normal tax only there shall be allowed the following credits: . . . .**

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213; . . . .

The foregoing section applies to individuals. Corporations may take credit under section 236 (a) for similar interest. The interest here described is that included within the definitions of gross and net income by virtue of the fact that these particular public securities do not fall within the scope of section 213 (b-4-c).

In the case of all the Liberty loans since the first, and of the Victory 4¾ per cent issue, the interest, except that on certain specified amounts, has been made subject to the individual surtaxes and to the excess and war profits taxes. The sections quoted above provide the machinery for exempting the interest from the normal tax of individuals and the corporation 10 per cent (12½ per cent after December 31, 1921) tax and yet rendering it subject to the surtax and excess profits tax. For a full discussion see Chapter XX.

Income Exempt from Both Normal and Surtaxes

In section 213, which, it will be recalled, applies to both individuals and corporations, certain items are definitely excluded from the definition of gross income and consequently

need not be reported at all. These items will be considered separately in the pages which follow.

War risk insurance and pensions from United States exempt.—

LAW. Section 213. That . . . . the term "gross income"— . . . . (b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war; . . . .

The foregoing provision is new.[31]

Accident and health insurance exempt.—

LAW. Section 213. That . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;[32] . . . .

The foregoing exemption has been extended to the estate or other beneficiaries in case the insured is deceased.

REGULATION. . . . . (c) Whether he be alive or dead, the amounts received by an insured or his estate or other beneficiaries through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are excluded from the gross income of the insured, his estate and other beneficiaries. Any damages recovered by suit or agreement on account of such injuries or sickness are similarly excluded from the gross income of the individual injured or sick, if living, or of his estate or other beneficiaries entitled to receive such damages, if dead. . . . . (Art. 72.)

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[31] Payments under the War Risk Insurance Act made since June 25, 1918, were exempted by the act under which paid (Reg. 45, Art. 72). Payments under the Vocational Rehabilitation Act were taxable (C. B. 4, page 79; Sol. Op. 97). Pensions were taxable under the 1918 law (Reg. 45, Art. 32).

[32] This exemption, first introduced in 1918, resulted from court interpretations of earlier laws. See *Income Tax Procedure,* 1920, page 40.

Rulings. The alienation of a wife's affections is not such a personal injury as to entitle the recipient of damages therefor to exemption from income tax as to the amount received. (C. B. 2, page 71; S. 1384.)

Damages in the form of yearly payments throughout the life of the injured party, recovered through the compromise of a threatened suit for breach of promise of marriage, are not regarded as a return of capital, since the benefits of which the injured party was deprived were merely anticipatory. Such payments are within the statutory definition of income and accordingly are taxable to the recipient. (C. B. 2, page 70; O. D. 501.)

Life insurance—extent to which exempt.[33]

When paid to beneficiaries.—

Law. Section 213. **That . . . . the term "gross income"—**

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured;[35] . . . .

The foregoing provision definitely exempts the proceeds of all life insurance.[34]

Rulings. A and B, beneficiaries under life insurance policies covering the lives of their respective husbands, accepted the option of allowing the proceeds thereof to remain with the insurance company to draw interest at the rate of 3 per cent per annum, plus the amount of any excess interest dividends; the principal sum to be paid upon the death of the beneficiary to the beneficiary's legal representatives. In one case the option accepted was provided for in the policy, and in the other it was offered by the company independently of the policy.

Held, that as the beneficiary in either case had the option of receiving the proceeds of the insurance or of leaving the money with

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[33] For exemption relating to insurance companies, see Chapter XXXVIII.

[34] [Former Procedure] The 1913 law exempted "the proceeds of life insurance policies paid upon the death of the person insured" [section II (B)]. The regulations under the 1918 law attempted to tax the proceeds paid to the estate of the insured, but this was reversed by T. D. 3190, July 1, 1921. The 1918 law exempted insurance paid to individual beneficiaries or to the estate of the insured, but excluded from the exemption payments to corporations.

[35] Policies payable to partnerships (except limited partnerships of the corporate type) are in effect payable to individual beneficiaries. (C. B. 1, page 82; T. B. R. 22.)

the company to draw interest, she in effect has loaned the money to the company, and the interest so received thereon is taxable income for the year of its receipt.

In the policies covering the life of C's husband, provision was made that C should receive only an annual payment representing 3 per cent of the principal of the policy, together with any excess interest dividends apportioned to the policy. C may not receive any part of the principal, but at her death the entire sum is to be paid to certain named beneficiaries of the insured.

Held, that the annual payment received by C represents a part of the proceeds of an insurance policy, and is therefore exempt from income tax in her hands. (C. B. 3, page 120; O. D. 612.)

Where under a life insurance policy there is payable to a first beneficiary named 6 per cent per annum of the face value of the policy during the life, and, upon the death of the first beneficiary, the face value of the policy is payable to a second beneficiary, the payments to the first beneficiary are a part of the proceeds of the policy within the meaning of section 213 (b) 1 of the Revenue Act of 1918, and are not to be included in gross income for the purpose of the income tax. (C. B. 2, page 90; O. 995.)

Amounts received by an individual beneficiary or by the estate of the insured under the terms of an ordinary life, continuous installment bond contract issued by a life insurance company are exempt from tax under the provisions of section 213 (b) 1, Revenue Act of 1918. This applies not only to the installment payments received but also to any dividends received under the terms of the bond. (C. B. 2, page 91; O. D. 433.)

According to the nomination of the beneficiary signed by the insured the principal of the policy is to be held by the insurance company as trustee for the benefit of his widow during her life and upon her death for the benefit of his son until he has attained the age of 30 years.

The right of withdrawal is withheld from the widow during her life and his son until he reaches the age of 30, unless the income therefrom for the period of a year falls below 4½ per cent of the principal, in which case the beneficiary has the right to withdraw all that part of the principal on which the beneficiary may be entitled to draw interest income.

Held, that any interest received by the widow during her life, or by the son prior to his reaching the age of 30, so long as such income is not less than 4½ per cent of the principal, is exempt from income tax. In case the income from the principal falls below 4½ per cent, the income is taxable to the beneficiary, regardless of whether the principal is withdrawn or left in the hands of the company, and any interest received thereafter shall be taxable to the beneficiary

whether more or less than 4½ per cent of the principal. The yearly income from the principal will be taxable to the son upon his arriving at the age of 30 years. (B. 35-21-1790; O. D. 1010.)

The law says "*proceeds* of life insurance policies" are exempt. These interpretations of the Treasury are of interest, but the courts may take a different view.

WHEN PAID TO THE INSURED.—

LAW. Section 213. That . . . . the term "gross income" . . . .

(b) Does not include . . . .

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract; . . . .

Dividends received on life insurance policies that have not matured, whether such dividends are drawn in cash by the insured or applied to the reduction of the annual premium due, are not considered items of taxable income under the law and should be excluded from a return of income. The same rule applies to dividends declared on endowment and other policies until the maturity of the contracts.

Dividends from paid-up policies, however, are considered ordinary dividends, and when the taxpayer's net income is sufficiently large, are subject to the surtax.

REGULATION. . . . . (*b*) During his life only so much of the amount received by an insured under life, endowment, or annuity contracts as represents a return, without interest, of premiums paid by him therefor is excluded from his gross income. . . . . (Art. 72.)

The law does not specify the method of reporting the amount received by the assured under an endowment or cancelled policy in excess of premiums paid. As is apparent from the regulations quoted above, the Treasury holds that the entire amount received in excess of premiums paid is taxable income for the year during which received. In view of the expressed purpose of the law in other sections, that no income or gain which accrued prior to March 1, 1913, is to be taxed, it must be assumed that the same intention applies to this sec-

tion. Even if it were not the intention, it is not likely that the courts would uphold any attempt to tax amounts accrued in excess of premiums prior to March 1, 1913. Therefore it would seem to be proper to value an endowment or similar policy as of March 1, 1913, and upon any realization thereof account only for the excess cash received over the sum of the value at that date and the amounts paid by the policyholder between March 1, 1913, and time of realization. It would be difficult for a policyholder to calculate the value, but the insurance company should furnish the necessary information.

Likewise during the years prior to maturity or payment, if the individual keeps his books upon the accrual basis, there would seem to be no objection to reporting each year's accrual so that upon collection of the principal sum there will be no necessity for reporting in one year the entire excess above premiums paid. In the case of large endowment policies the question is important.

Gifts and inheritances exempt.[36]—

LAW. Section 213. That . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income), ...

REGULATION. Money and real or personal property received as gifts, or received under a will or under statutes of descent and distribution, are exempt from tax, although the income therefrom derived from investment, sale, or otherwise is not. . . . . An amount of principal paid under a marriage settlement is a gift. . . . . (Art. 73.)

The foregoing section merely states that the value of property acquired by gift need not be included in gross income. A tax on property acquired by gift would be a property tax and could not be held to be income as income has been defined

[36] The 1921 law attempts to tax donees on gains realized by sale. See Chapter XVII. This provision, if valid, makes a radical change in the consideration of gifts.

by the United States Supreme Court, nor taxed as such. In the 1921 law appears for the first time an attempt to tax *such part* of the *proceeds* of gifts as represents accrued gain at the date of the gift. It is claimed that the gift itself is not taxed but only the untaxed gain contained in the gift. Against this is the contention that the imposition of a so-called income tax on donees based on a time and a base over which donees have no legal control, and usually no knowledge at all, is purely and simply a tax on the capital interest with which donees become seized at the date of gift.

It should be noted that no attempt is made to tax gifts as such; the tax referred to only becomes effective when, as and if donees sell or exchange the property acquired by gift.

This chapter deals only with exempt income. It may be said therefore that, as in all other income tax laws, property acquired by gift is exempt from the income tax.

If money or other property is acquired in a manner about which there is a doubt, the transaction may be inquired into. If it is determined that legal consideration is an element, the value of the property may be wholly or in part income, depending on the circumstances of each case.

It is apparent that in many cases the proper course of action for the recipient of a gift which might seem to be somewhat in the nature of compensation for services rendered is determined by the action of the person who made the payment. If the giver desires to deduct the item as an expense, the recipient can scarcely object to reporting any payment of this nature actually received as taxable income. Here, as in so many cases, good faith and a disposition to yield on really doubtful points are essential to the successful administration of the income tax law.

Transactions in which the element of taxability is stronger than that of exemption are discussed in the appropriate chapters dealing with income from services, gains or sales, etc.

Gifts which have been held to contain no element of taxable income are illustrated by the following rulings.

Ruling. Personal transportation passes issued by a railroad company to its employees and their families, to be used when not engaged on business for the company, and which are not provided for in the contracts of employment, are considered gifts and the value thereof does not constitute taxable income to the employees. (C. B. 4, page 110; O. D. 946.)

Ruling. Held, that the question as to whether a gift from husband to wife is bona fide must be considered in the light of the intent of the donor, from all available facts, and that where a transfer is made by unconditional endorsement of securities, failure to record the transfer on the books of the corporations and the deposit of income from such securities in a joint account, are not conclusive that the gift was colorable. (C. B. 4, page 107; A. R. R. 367.)

Colorable gifts.—It is reasonable to insist that gifts must be irrevocable and *bona fide* in order that subsequent realized gains or income will be taxed to the donees instead of to the donors. Usually the element of consideration controls. Where there is no family relation (where the consideration of "love and affection" is sufficient) it should be shown that the consideration is reasonable.

In the case of bequests the element of consideration does not enter, and no attempt has been made to tax as income property acquired by bequest.

Ruling. The following rules should be followed by the Bureau of Internal Revenue in distinguishing a case of an actual gift and a case of a merely colorable gift:

(a) Where it appears that the owner of property has purported to transfer it without consideration to a member of his own family, or to any other person with whom he is in confidential relations, and that shortly thereafter a profitable sale of the security or property so transferred has occurred, such facts constitute prima facie evidence that the purported gift was not an actual gift and that the transfer was, in fact, merely colorable. In such case the so-called gift should be ignored in calculating tax, and the case should be investigated for evidence on which a charge of fraud could be supported in a contest.

(b) The prima facie case made out by the facts mentioned in the preceding paragraph may be rebutted by proof which establishes that it was not a transaction primarily for the advantage of the donor, and that there was no agreement or understanding, tacit or otherwise, that the donor was to receive back the proceeds or at any time control their disposition. Mere statements by the parties to the effect that the gift was genuine are regarded as of little weight; the best proof that a gift was a real gift would consist of facts showing that the position or relationship of the parties is such as to show a reasonable occasion for such a gift being made, and such as to explain the sale by the donee. Inquiry should be made as to the disposition of the proceeds.

(c) Where a taxpayer purports to make a gift to a member of his family or to a person in a confidential relation to himself, but no sale occurs, the question whether such gift was real or merely colorable is one to be decided on all of the facts. The mere fact that such conveyance is made may not lawfully be regarded as proof of fraud; but if the effect of the gift is to diminish tax liability, and it appears, either at the time of the gift or at any time thereafter, that the donor is deriving advantage from the property which he purported to give away, such facts constitute prima facie evidence that the gift was only colorable and the transaction should be treated as a nullity unless other facts are developed which show that it was a true gift. If such a gift is colorable only and made for the purpose of escaping tax, the donor is guilty of fraud and subject to penalty and punishment therefor. (C. B. 1, page 83; S. 1022.)

The foregoing is clear and reasonable. There is no indication of an intention to tax the proceeds of sales by donees when the gifts are bona fide.

An attempt was made in January, 1921,[37] to obviate the tax evasion made possible because of the "colorable gifts" referred to above. The bill in question was not passed at the time but has been enacted in substance into the 1921 law.[38]

The same difficulty was faced by New York State under its personal income tax law. An attempt was made to tax to the donor the appreciation in value at the time of gift, but the attempt was held to be unconstitutional.[39]

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[37] H. R. 14198.

[38] Section 202 (a-2), see Chapter XVII.

[39] *People ex rel. Wilson v. Wendell,* 188 N. Y. Supp. 273; *People ex rel. Brewster v. Wendell,* 188 N. Y. Supp. 510.

WHEN A SO-CALLED PENSION[40] IS A GIFT.—

RULINGS. The terms "pension" and "gift" are not mutually exclusive. A payment may be both a pension and a gift.

When a pension is given by one for whom services are performed in consideration of such services, even though it be granted after the services have been rendered, the pension is not a gift but in the nature of additional compensation.

When, however, so-called pensions are awarded by one to whom no services have been rendered, such payments become mere gifts or gratuities and do not constitute taxable income. Payments by the Carnegie Foundation for the Advancement of Teaching, made to teachers and the widows of teachers, fall into the latter class. Law opinion 560 is modified to conform hereto. (C. B. 2, page 73; O. D. 361, overruled.) (C. B. 3, page 120; L. O. 1040.)

A corporation paid to the widow of a deceased officer a certain amount equal to the salary he would have earned in two months. The payment was without consideration, a gratuity voted as a compliment to the deceased. It is held that the payment does not constitute taxable income. (B. 36-21-1798; O. D. 1017.)

Interest which is exempt from both normal and surtaxes.—

LAW. Section 213. **That . . . . the term "gross income"— . . . .**

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;[41] or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916,[42] or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer from income, war-profits and excess-profits taxes; . . . .

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[40] Military and naval pensions from the United States are now exempt [section 213 (9).] See page 351.

[41] **[Former Procedure]** The words "Territory" and "District of Columbia" were specifically included for the first time in the 1918 law. Under the 1916 law the word "State" was defined to "include any Territory, the District of Columbia," etc., "when such construction is necessary to carry out its provisions." (1916 law, section 15.)

[42] **[Former Procedure]** This clause was introduced by the 1916 law (section 4).

Regulation. Among income exempt from tax is interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia. Obligations issued for a public purpose by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities duly empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. The term "political subdivision" denotes any division of the State or Territory made by the proper authorities thereof acting within their constitutional powers for the purpose of carrying out a portion of those functions of the State or Territory which by long usage and the inherent necessities of government have always been regarded as public. Political subdivisions of a State or Territory, within the meaning of the exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. The purchase by a State of property subject to a mortgage executed to secure an issue of bonds does not render the bonds obligations of the State, and the interest upon them does not become exempt from taxation, whether or not the State assumes the payment of the bonds. (Art. 74.)

The precise degree to which the interest on the various issues of United States bonds is exempt from taxation is fully treated in Chapter XIX, "Income from Interest." Suffice it here to say that the only totally exempt securities are state and municipal bonds of any date, farm loan bonds, United States securities issued prior to September 1, 1917, the $3\frac{3}{4}$ per cent securities of the Victory Loan, and obligations of possessions of the United States. Totally tax-exempt interest need not be included in "gross income" at all. The 1918 law for the first time required, purely for information purposes, a statement concerning the taxpayer's holdings of such securities. The present law omits this requirement.

Rulings. Interest received on certificates of indebtedness known as "Fire relief certificates" issued in the State of Minnesota, is considered interest upon the obligations of a State and therefore not taxable. (C. B. 1, page 83; O. D. 30.)

Certificates of sale issued by a county or other political subdivision of a State in connection with the sale of property for nonpayment of taxes do not fall within that class of obligations of a State, county, or municipality, the income from which is exempt from Federal income tax. (C. B. 1, page 83; O. D. 327.)

Interest on promissory notes of a political subdivision of a State or Territory is exempt from tax under section 213 (b) 4 of the Revenue Act of 1918. (C. B. 4, page 110; O. D. 817.)

A municipality borrows money from a bank, issuing to the bank its promissory notes at a discount. It is provided that if the notes are not paid when due, they will also draw interest from maturity until paid.

Held, that both the discount and the interest on the notes after maturity are exempt from income and profits taxes in the hands of the bank. (C. B. 4, page 110; O. D. 856.)

Interest paid by the contractor on funds advanced by a bank on certificates of indebtedness of a municipality, and discount charged by the bank for cashing such certificates, are deductible from gross income.[43]

RULINGS. The interest received upon Philippine 4 per cent bonds of 1914-34 is exempt from the taxes imposed by the Revenue Act of 1918. (C. B. 4, page 111; O. D. 922.)

Where the executors under a will hold property specifically bequeathed to a governmental agency of a State, and other assets of the decedent's estate are sufficient to pay all debts, income received by the executors during the period of administration from such property is not taxable in the hands of the executors under section 2 (b) of the Act of 1916. (C. B. 2, page 96; S. 1374.)

In the ruling last quoted the question at issue was the taxability of income from property specifically bequeathed to a state university, but still held by the executors during the period of administration.

Certain dividends exempt from both normal and surtaxes.—

FEDERAL LAND BANK AND FARM LOAN ASSOCIATION DIVIDENDS EXEMPT.—

REGULATION. As section 26 of the Federal Farm Loan Act of July 17, 1916, provides that every federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of federal land banks and

[43] B. Digest 34-21-1778; O. D. 999.

national farm loan associations and from interest on such farm loan bonds is not subject to the income tax. . . . . (Art. 75.)

FEDERAL RESERVE BANK DIVIDENDS.—

REGULATION. As section 7 of the Federal Reserve Act of December 23, 1913, provides that federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, such exemption attaches to and follows the income derived from dividends on stock of federal reserve banks in the hands of the stockholders, so that the dividends received on the stock of federal reserve banks are not subject to the income tax. Dividends paid by member banks, however, are treated like dividends of ordinary corporations. (Art. 76.)

Compensation for active war service exempt.[44]—No exemption for war service is allowed under the 1921 law. The exemption allowed under the 1918 law expired automatically with the Joint Resolution of Congress dated March 3, 1921. The period of its effectiveness extended from January 1, 1918, to March 3, 1921.[45]

Dividends and interest from domestic building and loan associations.—The exemption, under the 1921 law, of dividends and interest from domestic building and loan associations to a maximum of $300 per annum, is entirely new.

LAW. Section 213. **That . . . . the term "gross income"— . . . .**

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300; . . . .

The ambiguity in the amount of the exemption is discussed in Chapter XIX.

Rental value of minister's house not taxable.—

LAW. Section 213. **That . . . . the term "gross income"— . . . .**

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[44] *Income Tax Procedure,* 1921, page 51 *et seq.* The exemption did not apply to the Public Health Service (B. 47-21-1932; T. D. 3242).

[45] C. B. 4, page 112; O. D. 900.

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation; . . . .

This provision removes an anomaly that existed in the 1918 law under which compensation received in this form was taxable. Under the latter circumstances the property of an exempt body, a corporation operated exclusively for religious purposes, was indirectly taxed.

Shipowners' mutual protection and indemnity associations.—

LAW. Section 213. That . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(12) The receipts of shipowners, mutual protection and indemnity associations, not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or member, but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rents. . . . .

The exemption of premiums collected and received by shipowners' mutual protection and indemnity associations is included for the first time in the 1921 law. Mutual marine insurance companies, as such, receive certain exemptions.[46] The above specific provision brings shipowners into line with farmers and other purely local organizations wherein protection is sought without any design to secure other monetary benefits to the members.

BONUS FROM STATE NOT TAXABLE.—

RULING. A bonus paid by a State to its residents who served in the military or naval forces during the war with Germany does not constitute taxable income to the recipient. (C. B. 1, page 83; O. D. 286.)

The exemption is based on the ground that the bonus is a gift.

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[46] See Chapter XXXVIII.

Income of foreign governments exempt.—

LAW. Section 213. That . . . . the term "gross income"— . . . .
(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States; . . . .

REGULATION. The exemption of income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax. . . . . (Art. 86.)

This article was heretofore numbered 83.

RULING. Income derived by a foreign corporation from sources within the United States is subject to Federal tax, regardless of the fact that 51 per cent of its stock is owned by a foreign Government. If such income comes within the classes contemplated by sections 221 and 237, it is subject to withholding. (C. B. 4, page 111; O. D. 958.)

The term "foreign government" as defined in article 382 (see ChapterXXVIII) excludes cities such as Montreal and Paris, and it would follow that any income derived in the United States by such cities would be subject to tax. The author believes that the Treasury's definition, in this case, is not in accord with the law.

INCOME OF FOREIGN AMBASSADORS AND MINISTERS.—

REGULATION. . . . . The income from investments in the United States in bonds and stocks and from interest on bank balances received by ambassadors and ministers accredited to the United States and the fees of foreign consuls, are exempt from tax, but income of such foreign officials from any business carried on by them in the United States would be taxable. As under international law the benefits and immunities of ambassadors and ministers of foreign countries extend to the members of their households, including attachés, secretaries, and servants, the foregoing provision is likewise applicable to the wives and minor children of foreign ambassadors and ministers and the members of their households. The compensation

of citizens of the United States who are officers or employees of a foreign government is, however, not exempt from tax. (Art. 86; Reg. 45, Art. 83.)

The authority for this exemption is not found in the law. If the ambassadors, ministers and consuls were abroad, their income from the United States from the sources mentioned would be subject to withholding. It is not clear why the usual "courtesy" exemption from personal taxes, such as customs duties, should be extended to withholding on account of income taxes.

As an embassy is deemed to be foreign soil, those who reside in it should be taxed as if they were actually on foreign soil. If Great Britain followed our practice an ambassador from the United States to Great Britain would be exempt from British income tax on his investments in that country.

Ruling. Only foreign diplomats, ambassadors, and other diplomatic representatives in charge who are accredited to the United States to represent their sovereign or country and who reside here, and the members of their staff are entitled to exemption from tax on income from investments in bonds and stocks and from interest on bank balances. Foreign consuls resident in the United States are not entitled to the exemption. (C. B. 1, page 91; O. D. 336.)

Although formerly ruled to the contrary,[47] the privileges afforded foreign diplomatic officers have been extended to embrace their wives and minor children.[48]

Compensation of the President and United States judges no longer exempt.—The exemptions specifically provided in the law are all covered by the foregoing sections. It should be particularly noted, however, that the exemption formerly extended to the compensation of the President of the United States and United States judges is no longer contained in the law. On the contrary, the salaries of the President and United States judges are definitely declared to be taxable. Other federal employees continue to be taxable as formerly.

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[47] C. B. 1, page 90; O. D. 153.
[48] Bulletin 48-21-1945; O. D. 1115.

Article 32 of the regulations provides that the President and federal judges are not subject to a new tax or an increased tax if elected or appointed to office prior to the passage of the law.

While the Supreme Court has decided[49] that the salaries of federal judges and the President of the United States could not be taxed because the federal constitution prohibited any diminution of such salaries during continuance in office, the Attorney General in an opinion dated June 21, 1920,[50] stated he was "unable to see, ... that there is anything in the recent opinion of the Supreme Court which relieves a judge appointed *since the enactment of the income tax law* from paying the tax imposed by that law." This is further discussed in Chapter XIV.

Compensation of state and municipal employees exempt.—

REGULATION. Compensation paid its officers and employees by a State or political subdivision thereof, including fees received by notaries public commissioned by States and the commissions of receivers appointed by State courts, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless the person receives such compensation as an officer or employee of a State or political subdivision. An officer is a person who occupies a position in the service of the State or political subdivision, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary. Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a State, are not required to return as taxable incomes the salaries so received. This is also true with respect to the act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the act of March 2, 1887, relating to agricultural experiment stations in such colleges. . . . . (Art. 88.)

This article was heretofore numbered 85. The new article

[49] *Evans v. Gore*, 253 U. S. 245; 64 L. Ed. 887; 40 Sup. Ct. 550.
[50] 32 Op. Att. Gen. 248.

contains a definition of a state officer which did not appear in Regulations 45.

On May 6, 1919, the Attorney General rendered an opinion that "salaries of state officials and salaries and wages of employees of a state are not subject to the income tax imposed by the said Revenue Act of 1918."[51]

The author's understanding of the intention of the framers of the 1918 law is that state employees were to be taxed. But in view of the foregoing ruling there will, of course, be no judicial interpretation of the law.

RULINGS. The compensation received by the employees of a certain public library, a corporation, is not exempt from taxation, although the salaries and other principal expenses of the corporation are paid out of money appropriated by the State or city and the power of appointment and removal of the employees is exercised by the board of directors, three of whom are officials of the city and two of the remaining directors are appointed by the mayor. (B. Digest 28-21-1725; O. D. 973.)

Salaries paid to teachers are exempt from income tax only where the educational institution is maintained wholly by the State, and the relation of employer and employee exists between the State and the teacher. They are not exempt merely because engaged in educational work, nor because they are pensioned by the State. (C. B. 1, page 93; O. 826.)

This subject is further discussed in Chapter XIV.

Alimony not taxable.—Although not one of the specified exemptions, it is important to note here that a person receiving alimony need not take it into account at all in making an income tax return. Reversing former procedure,[52] the Supreme Court of the United States[53] in 1917 held that alimony is not to be considered income to the recipient, nor an item of deductible expense to the payer. This, of course, is the final word on the subject.

[51] T. D. 2843, May 17, 1919.

[52] [**Former Procedure**] T. D. 2090 (December 14, 1914) held that alimony was a personal expense, not deductible by the person paying but taxable to the person receiving, the tax being subject to withholding at the source.

[53] *Gould v. Gould*, 245 U. S. 151; 62 L. Ed. 211; 38 Sup. Ct. 53 (Reg. 33, 1918, Art. 4).

Regulation. . . . . Neither alimony nor an allowance based on a separation agreement is taxable income. . . . . (Art. 73.)

Territorial Exemptions

The 1918 income tax applies, first, to individual citizens and residents of the United States and to domestic corporations (those created or organized within the United States) and, second, to non-resident alien individuals and to foreign corporations so far as their income arises from sources within the United States. A person whose stay in the United States is only temporary is not considered a resident.

The law states that "the term 'United States' when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia" (section 1). This definition, it will be noted, does not include Porto Rico or the Philippine Islands,[54] where the 1916 revenue law is still in force (1921 law, section 261).

Regulation. (*a*) A citizen of the United States who resides in Porto Rico, and a citizen of Porto Rico who resides in the United States, are taxable in both places, but the income tax in the United States is credited with the amount of any income, war profits, and excess profits taxes paid in Porto Rico. . . . . (*b*) A resident of the United States, who is not a citizen of Porto Rico, is taxable in Porto Rico as a nonresident alien individual on any income derived from sources within Porto Rico, but the income tax in the United States is credited with the tax paid in Porto Rico. (*c*) A resident of Porto Rico, who is not a citizen of the United States, is taxable in the United States as a nonresident alien individual on any income derived from sources within the United States, and receives no such credit. . . . . The same principles apply in the case of the Philippine Islands. (Art. 1132.)

[54] [Former Procedure] The 1916 law states "that the word 'state' or 'United States' when used in this title shall be construed to include any territory, the District of Columbia, Porto Rico, and the Philippine Islands, when such construction is necessary to carry out its provisions" (section 15). The 1917 law imposing the war income tax did not extend to Porto Rico and the Philippines, as is shown by the following section: "That the provisions of this title shall not extend to Porto Rico or the Philippine Islands, and the Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify or repeal the income tax laws in force in Porto Rico or the Philippine Islands respectively."

The 1918 law continued this provision.

The same principle applies in the case of corporations similarly situated (article 1133).

It is to be noted that under the provisions of an Act of Congress, known as "An Act making appropriations for the naval service for the fiscal year ended June 30, 1922, and for other purposes,"[55] it was *"Provided further*, That the income tax laws now in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands." This act has been ratified and confirmed from and including July 1, 1921.

Exemption of profits from sales of vessels.—The provision in the Merchant Marine Act of 1920[56] exempting for ten years from tax the gains arising from the proceeds of certain vessels referred specifically to the taxes imposed by the Revenue Act of 1918. Of course, the "Revenue Act of 1921" is not the "Revenue Act of 1918," but as the Merchant Marine Act is still in force and as the exemption was to be for ten years, it should be held that the gains to be exempted are the *same* as those imposed by the Act of 1918 and that full exemption should be granted for the ten-year period. In any event, the exemption is applicable for the year 1921.

The Treasury has held that the sale of the entire capital

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[55] Public Law, No. 35, 67th Congress.

[56] **[Former Procedure]**

LAW. "That during the period of ten years from the enactment of this Act any person a citizen of the United States who may sell a vessel documented under the laws of the United States and built prior to January 1, 1914, shall be exempt from all income taxes that would be payable upon any of the proceeds of such sale under Title I, Title II and Title III of the Revenue Act of 1918 if the entire proceeds thereof shall be invested in the building of new ships in American shipyards, such ships to be documented under the laws of the United States and to be of a type approved by the board [i. e., the United States Shipping Board provided for by Section 3 of the Act.]

"'Merchant Marine Act, 1920,' of which the above is the second paragraph of Section 23, approved by the President, June 5, 1920. (Merchant Marine Act, 1920, section 23, paragraph 2.)"

stock of a company owning ships, even though the proceeds of such sale were reinvested in American ships, could not be brought within the privileges of the act on the ground that the law specifically provides that the exemption applies only to the sale of ships.

CHAPTER XIII

INCOME IN GENERAL

Plan of treatment.—The following chapters discuss in detail the various types of income subject to the income tax. Income from personal services, business, property, interest, rents, dividends, etc., are taken up in regular order and the procedure peculiar to them is explained. However, in addition to these particular subjects there are many questions which are general in their nature and application. These are brought together for treatment in this introductory chapter.

Variations according to class of taxpayer.—It should be observed that, in the absence of an indication to the contrary, statements made in the text are to be accepted as applicable to corporations and individuals alike. So much of the procedure applies to all classes of taxpayers that it has been deemed desirable to isolate only the exceptional points, indicating plainly in such cases the limitations upon the application.

It is almost impossible to frame a revenue law which will distribute the tax burden with exact equality over various classes of taxpayers. There are fundamental points of difference between businesses operated by corporations and by individuals, which cannot easily be equalized. Partnerships are held to be nothing more than two or more individuals acting together for convenience. Attempts have been made to regard partnerships as entities, but thus far the courts have not departed from the common-law principle that partnerships enjoy no privileges and need bear no burdens other than those incident to individuals. This principle, however, is an ancient one and it is within the range of possibilities that in the near future some court will hold that common-law partnerships are independent legal entities, taxable as such, and possessing

privileges and burdens which differentiate them from individuals or corporations.[1]

The repeal of the inequitable and unsatisfactory excess profits tax will require some adjustment of taxes upon business, as distinguished from taxes upon income from other sources. It may be that the best solution will be to impose the same rate of tax upon business enterprises, no matter how conducted. This in turn will require an adjustment of the unduly high surtax rates.

"Catch-all" provision.—The law states (section 213) that "gains or profits and income derived from any source whatever" are subject to the tax. To provide for possible lapses in the law and regulations the following "catch-all" provision was included in a previous edition of the regulations. The statements made are still pertinent.

Regulation. The intent and purpose of the income tax law is that all gains, profits, and income of a taxable class shall be charged and assessed with the corresponding income tax, normal and additional, and such tax shall be paid by the owner of such income or the proper representative thereof having the receipt, custody, control, or disposal of the same. In any case where the conditions which obtain do not appear to fall within the law and regulations for the assessment and collection of the income tax, the proper tax shall be assessed in the particular case by the Commissioner of Internal Revenue upon his findings concerning the same. Ownership of income and liability for tax thereon shall be determined as of the year for which the return is required to be rendered. (Reg. 33, 1918, Art. 49.)

Ruling. A, upon becoming an officer of the M Company, invested in the capital stock of the company at par and later purchased additional shares. It appears that at the time of purchase of this stock

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[1] See Massachusetts Income Tax Law, General Acts of 1916, Chapter 269, section 10, which reads in part as follows:

"The tax shall be assessed on such a partnership by the name under which it does business, and the partners shall not be taxed with respect to the income derived by them from such a partnership."

Oliver v. Lynn (130 Mass. 143), holds that the tax on partnership property is a separate tax against the partnership, and that an individual partner cannot sue for the recovery of such a tax unless it is proved to be wholly illegal.

it was agreed, and so provided by the by-laws of the company, that should any employee holding common stock sever connection with the company, such employee should sell to the company all the common stock so held, receiving therefor its book value. In 1918 A severed his connection with the M Company, and under the terms of his agreement surrendered his stock, receiving book value therefor, such book value being x dollars in excess of the amount paid therefor. A protests against taxation of this profit on the ground that the sale was not voluntary.

This Committee is of the opinion that this protest is without merit, since there is no warrant of law for exempting profits actually realized from tax because such realization is involuntary. . . . . (C. B. 1, page 66; A. R. M. 1.)

Nature of taxable income.—The concept of income adopted in the law is not an entirely clear and logical one. In general it imposes the tax only when the income is reduced to money, but in certain cases this rule is not followed, the law taxing some income in forms other than money.[2]

In some respects the 1921 law is an improvement over past laws. Capital gains and profits are still subject to the tax (as they should be) but at a reduced rate for large incomes.

What is needed is an authoritative definition of "income." This cannot be found in the decisions of the Supreme Court, because there are too many differentiations and limitations to make it clear what a decision will be in any future case.

The following definition of income is of interest. It should, however, include the world "realized" when applied to taxable income:

Income is the money value of the net accretion to one's economic power between two points of time[3]

It appears from some court decisions that doubt exists as to the taxability of certain transactions which involve so-called

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[2] The 1917 and former laws purported to tax only realized income but the Treasury assessed taxes on many exchanges in which there was no realized income. The 1918 law contains a formula for computing income in the case of exchanges which depends more on par or face value of securities than on actual values.

[3] Robert Murray Haig. "The Concept of Income—Economic and Legal Aspects," *The Federal Income Tax*, Columbia University, 1921.

capital. In a recent case[4] the Circuit Court of Appeals, Second Circuit, held that a gift to a corporation is not taxable income. In defining the word "income"[5] the court said: ". . . . it (income) should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation." One judge, dissenting, said: "I find no difficulty in calling it (the gift to the corporation) income."

Under the circumstances, no apology is needed to justify a careful inquiry into the right of Congress or of the Treasury to extend the taxation of income—which is permitted under the sixteenth amendment—to the taxation of capital—which is not permitted. Such an inquiry naturally should cover the right to tax any transaction unless there is an actual realization of income, as distinguished from the apparent income which may be and often is the result of temporary fluctuations in values.

Income in cash or equivalent.[6]—The use one enjoys of his own property—as, for example, the house in which the owner lives—is not considered taxable income. Ordinarily income, to be taxable, must be in the form of money. Thus, the farmer's crop is not taxable until it has been reduced to cash (if the inventory method is not used)[7] and one piece of property exchanged for another when neither has a "readily

[4] *U. S. v. Oregon-Washington R. & Nav. Co.*, 251 Fed. 211.

[5] "However, the tax, though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; i.e., wealth industrially employed in permanent form. It includes the earnings from a calling, as well as interest, royalties, or dividends, though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed."

[6] See Arts. 33 and 34, pages 438 and 437.

[7] See Chapter XXXIX.

realizable market value,"[8] gives rise to no immediate taxable income. However, income from personal services is taxable "in whatever form paid."[9] This is true apparently on the theory that in these cases there is some basis for the determination of the cash value of the income even though the income itself is in a form other than money, such as accounts receivable and mortgages.

REGULATION. . . . . Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. . . . . (Art. 22.)

SALES PROCEEDS IN ESCROW.—

RULING. Where a sale is made and because of claimants for commissions the seller is required by the purchaser to put a certain part of the purchase price in escrow, and thereafter certain claimants are paid directly out of said funds in escrow, the seller is not liable for income tax upon any part of the purchase price in escrow until actually received by him. (C. B. 2, page 82; S. 1315.)

A lease of oil lands contained a clause that the lease could not be assigned without the approval of the Secretary of the Interior. The lease was assigned in December, 1916, and the consideration therefor deposited in a bank in escrow pending the approval of the assignment, which was obtained in January, 1917. The Treasury held that title to the money deposited in escrow did not vest in the assignor until the approval of the assignment of the lease by the Secretary of the Interior, and therefore was income to the assignor in 1917. (I-3-31; L. O. 1082.)

CLOSED TRANSACTIONS IN PROPERTY.—The attempt to tax accretions of property values has raised an interesting series of problems turning upon the question. What constitutes a closed transaction or a realization definite enough to serve as

[8] Section 202 (b).
[9] Section 213 (a).

the basis for the imposition of a tax? This topic is discussed in detail in Chapter XVI.

"Gross" and "net" income.—The 1921 law devotes in the case of individuals, one section to the enumeration of the items included and not included in the term "gross income" (section 213) and another to "deductions" (section 214) and by declaring "net income" to be the remainder obtained by deducting the second from the first. The items, such as dividends, personal exemptions and interest on certain government securities, which are subject to the surtaxes but not to the normal tax, are provided for by a series of "credits" described in another section (section 216). As a result "gross" income is a special term which excludes certain items such as proceeds of insurance policies and gifts which are exempt from taxation. "Net" income is also a special term which, in the case of individuals, includes personal exemptions, dividends, etc. The same general plan is followed in defining the "gross" and "net" income of corporations (sections 232-236).

The explanation of the concepts of gross and net income provided in the regulations is as follows:

Regulation. The tax imposed by the statute is upon income. In the computation of the tax various classes of income must be considered: (*a*) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Income can not be determined merely by reckoning cash receipts, for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. . . . . (*b*) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by the statute.[10] . . . . (*c*) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income.[11] . . . . (*d*)

[10] See page 350 *et seq.*
[11] See Chapter XXV.

Net income less credits.[12] . . . . The surtax is imposed upon net income; the normal tax upon net income less credits. Though taxable net income is a statutory conception it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory "net income" is commercial "net income." This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. . . . . (Art. 21.)

Export sales.—Ordinarily there is little difficulty in determining "gross income"; but the question has arisen in case of exporting firms, as to whether or not they should include in income the profit from sales of goods shipped to customers against open drafts before the collecting banks in the foreign country report payment of the drafts.

When it has been the practice in the past not to include the profit on such sales until the draft is met, it seems proper to continue the practice.

In other cases when definite advices are received before March 15 of the succeeding year as to the disposition of drafts against shipments made prior to December 31 of the preceding year, and when it is then known that the drafts have not been met, it is proper not to include the profit on these sales, but to include the goods in the inventory.

Ruling. A corporation ships goods to foreign countries with the understanding that legal title does not vest in the purchaser prior to his acceptance of the draft which accompanies each bill of lading. Held, that the profits from the sale should not be included in the gross income of the corporation until the draft has actually been accepted and notice of that fact has been received by the corporation. Any goods shipped, the sale of which was not actually consummated as indicated above prior to the close of the corporation's taxable year, should be included in the closing inventory for that year. (C. B. 4, page 94; O. D. 824.)

Income accruing prior to March 1, 1913, not taxable.—

Regulation. Any claim existing unconditionally on March 1, 1913, whether presently payable or not and held by a taxpayer prior

[12] See page 337 *et seq.*

to March 1, 1913, whether evidenced by writing or not, and all interest which had accrued thereon before that date, do not constitute taxable income, although actually recovered or received subsequent to such date. Interest accruing on or after that date is taxable income. Where an interest-bearing claim held on February 28, 1913, is paid in whole or in part after that date, any gain derived from the payment of the claim is taxable. The amount of such gain is the excess of the proceeds of the claim (both principal and interest) exclusive of any interest accrued since February 28, 1913, already returned as income, over the cost thereof (both principal and interest then accrued). However, the gain to be included in gross income where the fair market value of the claim as of March 1, 1913, is greater than the cost thereof, is the excess of the amount received over such value. No gain results where the amount received from the claim is more than the cost thereof but less than its fair market value as of March 1, 1913. In the case of an insurance policy its surrender value as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition of such property. Where services were rendered prior to March 1, 1913, but paid for thereafter, the amount received is taxable income to the extent of the excess of such amount over the fair market value on March 1, 1913, of the principal of the claim and any interest which had then accrued. . . . . (Art. 90.)

When a valid and valuable claim existed, it would not seem to make much difference whether the right was conditional or unconditional.

Investment in non-taxable securities.—Many taxpayers are considering the relative advantages of investments in government and other non-taxable or partly taxable bonds as compared with investments in wholly taxable securities. The question arises both as to investment of income and as to change of investments held. Tables have been prepared by investment bankers and others which show the relative net return from taxable and non-taxable securities to recipients of income of different amounts. It is often possible for a taxpayer to reduce his tax burden by investing in non-taxable securities, but it must be borne in mind that tables which show comparative returns can be prepared only with reference to assumed conditions of investments and income. Each individual's tax, however, depends on the sources of his particular

income, whether from business activities, dividends, interest on bonds or other sources. Moreover, if changes in investments are made, there may be losses upon sales which materially affect the advantage of the changes. Consequently, a taxpayer who considers whether to invest in government bonds or other non-taxables should realize that not general information, but a study of his particular conditions of investments and income, is needed to determine what he would gain, as to taxes, by any investment. Particularly is this true in view of the contemplated further reduction in the upper brackets of the surtax.

Accounting procedure.—The 1921 law specifically provides that for income tax purposes the same methods of accounting shall be used as are "regularly employed in keeping the books,"[13] unless this "does not clearly reflect the income."

Law. Section 212. . . . (b) **The net income shall be computed . . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;[14] but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. . . .**

Regulations. (1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of "paid," "paid or accrued," and "paid or incurred."[15] All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. . . . A taxpayer is deemed

[13] Section 232 makes section 212 applicable to corporations.

[14] The provision was the same in the 1918 law. For summary of the provisions of former laws regarding the "accrual" and "cash" bases, see *Income Tax Procedure*, 1918, pages 67-70.

[15] See page 383.

to have received items of gross income which have been credited to or set apart for him without restriction. . . . . On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. . . . . (Art. 23.)

It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. . . . . Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year. . . . .;

(2) Expenditures made during the year should be properly classified as between capital and income, that is to say, that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. (Art. 24.)

Period for which net income is computed.—

Regulation. Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year.[16] . . . . The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. . . . . If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it. (Art. 22.)

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[16] Defined in section 200 (1).

Ruling. Adjustments made in accordance with instructions from the Interstate Commerce Commission, increasing the income of a railroad corporation from transactions in prior years and taken up on the books of the corporation during the taxable year because necessary information was not available prior to that time, represent income for the years during which the transactions took place instead of the taxable year. Corrections should be made by means of amended returns. (C. B. 1, page 58; O. D. 9.)

Regulation. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. . . . . The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. . . . . A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained. . . . . (Art. 111.)

The foregoing article sets forth good accounting practice. It recognizes that the best test of an adjustment is its relation to the business as a whole. It also describes the proper method of procedure when a loss is discovered in a fiscal year succeeding the year in which it should have appeared as a deduction.

Ruling. A restraining order of a court required that a part of the commissions received by the petitioners should be deposited with the Clerk of the Court, pending a determination of the ownership thereof, upon which determination the amounts deposited were to be refunded to the petitioners or distributed to their patrons from whom they were collected.

Held, that the commissions deposited need not be included in gross income until the taxable year of the judicial determination. (B. Digest 30-21-1743; O. D. 980.)

Amended returns required in certain cases.—The following indicates that the Treasury is ready to accept adjustments of returns of prior years, if such adjustments are necessary to reflect the true net income.

Ruling. Reference is made to your letter of June 2, 1920, in which you state that during the years 1915, 1916 and 1917 . . . . Company paid customs duties on imported merchandise on the basis of an exchange rate of a franc at 19.3 cents instead of the lower rate prevailing at the time of importation. It appears that the amount so paid as duties were included in the income and profits tax returns as part of the cost of goods sold during the years 1915, 1916 and 1917 and the surplus reduced each year to the extent of the duties paid. During the year 1919 the company received a refund of the amount so paid as customs duties which was in excess of the amount due on the basis of the exchange rate prevailing at the time of importation of the French merchandise.

You submit for consideration the following inquiries relative to the treatment of the transaction for income tax purposes:

(a) How should the transaction be treated in computing the annual net income for the years involved?

(b) Is not the amount allowed as a refund for duties overpaid in each year a credit to surplus for that year?

(c) Is not the attorney's fee and expense of collection an item of necessary business expense incurred in 1919 when the liability accrued and was paid?

In reply you are advised that the law contemplates that each year's return both as to gross income and deductions therefrom shall be complete in itself. The effect of the Treasury Decision under which the claim for refund of excess duties paid was allowed is to indicate that the excess revenue, which was paid during the years 1915, 1916 and 1917 and for which the company received a refund during the year 1919, is an amount which has been erroneously deducted in computing net income for the years 1915, 1916 and 1917 respectively rather than an amount which represents income for the year 1919.

Accordingly the company should amend its returns for the years 1915, 1916 and 1917, respectively, excluding from the cost of goods sold during each year the excess duties paid during such year. The surplus account for those years should also be adjusted by restoring to such account the amount paid as revenue in excess of the true liability for those years.

The attorney's fees and cost of collection of the refund are a necessary business expense for the year in which the liability accrued and was paid, which appears to be the year 1919. (Letter to S. D. Leidesdorf & Company, New York, N. Y., signed by Paul F. Myers, Acting Commissioner, and dated June 26, 1920.)

CASH OR ACCRUAL METHOD OF COMPUTING NET INCOME.—Under "definitions" the law contains the following:[17]

LAW. Section 200. . . . . **The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.** . . . .

The foregoing provisions are much more positive in tone than the permissive clauses included in the 1916 law and have been interpreted by the regulations to require the accrual basis for tax purposes when that method is used in the accounts.

REGULATION. . . . . "Paid" is to be construed in each instance in the light of the method used in computing net income, whether on an accrual or a receipts basis. . . . . (Art. 1533.)

All well-conducted business concerns attempt to make their books reflect actual net income for their accounting periods. When this is done in good faith the income tax return should exactly agree with the books, subject to statutory provisions.

Individuals do not, as a rule, keep books, and when they do their so-called accounts consist usually of cash records. But when reasonably accurate accounts are kept the taxpayer is more than repaid for the trouble involved. They assist economy and encourage thrift. Without accurate accounts an income tax cannot be satisfactorily assessed. The Com-

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[17] Same in 1918 law.

missioner will be justified in directing that every taxpayer be required to keep a clear record of gross income as it accrues and of expenses as they are incurred.

Nothing can be more obvious than the proposition that true "net income" cannot be determined by looking over one's cash account. Even day-laborers, many of whom now receive taxable incomes, often do not receive their wages in the period in which they are earned. It is not intended to suggest that taxpayers of this class should be required to prepare a return on the accrual basis; but if the wage-earner, whose wages for December, 1921, amounting to \$200, where not received by him until January, 1922, desires to include the \$200 in his 1921 returns, he should be encouraged to do so.

Ruling. Under the income tax statutes taxpayers are required to render true and accurate returns of annual net income in manner and form prescribed by the Commissioner with the approval of the Secretary of the Treasury. Any return which in the judgment of the Commissioner does not reflect the true net income of a corporation may be rejected by him and the taxpayer required to render a return on such basis as he may prescribe. Therefore, the action of the Unit in requiring a corporation engaged in the mercantile business, which made its returns for 1917 and 1918, on the basis of receipts and disbursements, to file amended returns on the accrual basis was proper and is approved.

The general plan which has been adopted with respect to mercantile corporations of requiring that both inventories and accounts receivable shall enter into the computation of net income is proper and in accord with the law and regulations. (C. B. 3, page 76; A. R. R. 217.)

Profit on consignment sales.—

Ruling. Profit on goods sold by a consignee is income to the consignor for the year in which the sales are made, even though the consignor received no notification of sale until a subsequent year. If reported otherwise, amended returns should be filed. (C. B. 1, page 66; O. D. 13.)

Changing from cash to accrual method.—If a taxpayer who has kept his books on a cash basis desires to change to an accrual basis, he must first secure the consent of the

Commissioner. It is most improper to change more than once unless the reasons are extremely cogent.[18]

In the long run the government is not likely to gain or lose anything by permitting one change, but if shifting back and forth were freely permitted it might easily develop into a scheme of wholesale evasion.

It is desirable for the taxpayer who contemplates a change in his method of reporting, to restate his accounts as of the beginning of the taxable year as well as at the end, and thus put all the current year's earnings and expenses on an accrual basis.

Regulation. . . . . (3) A taxpayer who changes the method of accounting employed in keeping his books for the taxable year 1921 or thereafter should, before computing his income upon such new basis for purposes of taxation, secure the consent of the commissioner. Application for permission to change the basis of the return shall be made at least 30 days before the close of the period to be covered by the return and shall be accompanied by a statement specifying the classes of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. . . . . (Art. 23.)

Rulings. Office Decision 481, ruling 18-20-893, modified by Office Decision 636, ruling 34-20-1144, is further modified so as to provide that where a farmer keeping his accounts on the cash receipts and disbursements basis desires to change to the accrual basis, and actual records or definite proofs are submitted which establish to the satisfaction of the Commissioner of Internal Revenue the existence of an animal or other production asset on a date previous to any date on which the farmer has paid income tax, inventory adjustments may be made in accordance with the instructions contained on page 4 of Form 1040-F. (C. B. 3, page 81; O. D. 685.)

A taxpayer, having reported his income prior to 1920 on the basis of cash receipts and disbursements, is not permitted to change from that basis because the books in his publishing business are now kept on an accrual basis, his accounts showing his income from a partnership being still kept on the cash basis and no formal books of account being kept to show his income from miscellaneous sources. (B. Digest 29-21-1731; O. D. 1731.)

A taxpayer who had heretofore computed his income and filed his returns on the accrual basis changed his method of accounting

[18] T. D. 2433 (January 8, 1917).

to the cash receipts and disbursements basis on June 30, 1921, the close of his taxable year, and applied to the Commissioner for permission to compute his income in his return for the 1921 fiscal year on the cash basis.

Held, that inasmuch as the change in his method of accounting was not made until the close of the taxable year, permission to compute income in his return for 1921 on the cash receipts and disbursements basis is denied. (B. 48-21-1941; O. D. 1113.)

A taxpayer who has properly filed his return on the cash receipts and disbursements basis can not be granted permission to amend it by stating that it is filed on an accrual basis, even though his cash receipts and disbursements were the same as his accrued income and deductions except as to the item taxes accrued to a foreign country. (B. 50-21-1971; O. D. 1133.)

Inventories.—The provision of the 1918 law regarding inventories marked a great advance over the earlier laws. Under the 1909 and 1913 laws the use of inventories was permitted in certain cases without the authority of any specific permission in the law and in spite of some doubt as to its legality. The 1918 law gave the Commissioner power to require inventories "whenever necessary clearly to determine the income of any taxpayer" and specified that the basis should "conform as nearly as may be to the best accounting practice in the trade or business." The 1921 law continues this requirement.

Fortunately, the determination of the "best accounting practice" is not difficult. Briefly defined, the term means accounts and methods which correctly reflect the true financial position of a concern as to net worth and earnings and which make it possible to secure advice which will prevent the proprietors or executives from deceiving themselves. The effect of federal income tax legislation upon accounting practice is interesting. Prior to 1909, conservative business men usually understated rather than overstated their net earnings, while ignorant and dishonest business men overstated them. After the enactment of the 1909 law, which imposed a tax on net earnings, the dishonest men began to understate their earnings and the honest and conservative men were inclined to overstate

their earnings in their desire to comply fully with the tax requirements.

Men cannot be made honest through legislation, but income tax legislation should contain ample penalties for false returns. Those who are honest can be depended upon to remain honest. The earlier income tax laws and regulations, in almost entirely ignoring the accrual system of accounting and in forbidding conservative methods of valuing inventories, actually reduced the revenue receipts of the government[19] and at the same time attempted to impose upon taxpayers impossible methods of accounting and valuation. These regulations bore most heavily upon honest and conservative business concerns but in no way worried the dishonest ones.

It is very gratifying to note the recognition now given to good accounting practice. It does not diminish the government's revenue and it enables taxpayers readily to prepare returns from accounts which accurately reflect true net income.

The subject of inventories is fully discussed in Chapter XV, "Income from Business." Also see Chapter XXV.

There are some businesses, it seems, in which the use of inventories does not reflect true net income.

RULING. The net income of a person engaged in the business of propagation and culture of oysters can not be properly computed upon the basis of inventories. Amended returns will be required for those years for which returns have been based upon inventories. The net income is the gross receipts for the year less the necessary business expense and other allowable deductions. (C. B. 3, page 80; O. D. 684.)

The Commissioner, however, has no authority to refuse permission to use the inventory method when its use (rather than the cash basis) more clearly reflects the annual income of the taxpayer.

"CONSTRUCTIVE" RECEIPT.—Even when the cash basis is used, the regulations provide that income must be reported

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[19] See *Income Tax Procedure,* 1918, pages 32-37, for concrete example.

when it is made available irrespective of whether or not it is actually reduced to possession. If an item is a "constructive" receipt it is taxable.

The following regulations cover this matter fully.

REGULATIONS. Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. If the income is not credited, but is set apart, such income must be unqualifiedly subject to the demand of the taxpayer. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. (Art. 52; Reg. 45, Art. 53.)

Where interest coupons have matured and are payable, but have not been cashed, such interest payment, though not collected when due and payable, is nevertheless available to the taxpayer and should therefore be included in his gross income for the year during which the coupons matured. This is true if the coupons are exchanged for other property instead of eventually being cashed. Defaulted coupons are interest for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the stockholder,[20] . . . . The distributive share of the profits of a partner in a partnership is regarded as received[21] by him although not distributed. . . . . Interest credited on savings bank deposits, even though the bank nominally have a rule, seldom or never enforced, that it may require so many days' notice in advance of cashing depositors' checks, is income to the depositor when credited. . . . . (Art. 53; Reg. 45, Art. 54.)

The phrase "unqualifiedly made subject to the demand of the stockholder" has been substituted for "set apart for," and the reference to constructive receipt of the distributive shares of personal service corporations is omitted.

RULINGS. Under the by-laws of a cooperative bank the profits credited to a shareholder may not be withdrawn in their entirety

[20] See Chapter XXII.
[21] See Chapter XXIV.

until five years have elapsed, but three-fourths of such profits may be withdrawn at any time upon 30 days notice, in which case the other fourth is forfeited.

The question presented is whether the profits credited to a shareholder of the bank are credited to or set apart for him without restriction, and, if so, whether the net amount which he might immediately withdraw or the whole amount credited to him should be reported as income.

Held, that three-fourths of the profits credited to the shareholder are credited to or set apart for him without restriction, and as such should be included in gross income for the year in which so credited or set apart. The remaining one-fourth becomes income, constructively received, at the end of the five-year period, provided he has not previously withdrawn his shares. (B. 44-21-1892; O. D. 1081.)

The donation by assignment of partnership profits to be earned in the future does not exempt such profits, when determined, from taxation as a part of the individual income of the donor. (C. B. 1, page 80; O. 912.)

Where an individual is employed as an agent for a firm and under his contract is to receive as compensation 50 per cent of the profits of the agency which may be appropriated by him monthly as earned, the amount actually appropriated constitutes income of the agent for the year in which appropriated. (C. B. 2, page 64; S. 1312.)

A distinction was drawn in this case between profits "credited or set apart" and profits "appropriated" by the individual who was entitled to draw against his share of profits. On this point the detailed opinion states:

RULING. Attorneys for the claimant make the contention that the claimant's portion of the monthly profits of the agency constitute income of the claimant each month; that is to say, the claimant's share of the profits are received by him during the month in which earned. This contention is based upon the ruling of this office contained in article 53 of regulations 45, the wording of which is "income which may be drawn at any time is subject to the tax for the year during which so credited or set apart, although not then actually reduced to possession." This contention is not valid for the reason that the profits of the agency are not credited to him or set apart month by month. The contract of employment provides that such profits "shall be and are the property of M."

This ruling is not convincing. It seems that an agent who is entitled to 50 per cent of the profits of a business should be required to report all of the earnings which accrued to him

during each period rather than the amount "appropriated." If he had not "appropriated" any part of the earnings it is hardly likely that the Treasury will permit him to say that he had no taxable income.

RULINGS. Held, that commissions duly authorized and credited as compensation for services, when under control of the creditor and subject to his draft, should be treated as taxable income for the year in which credited, even though not reduced to possession in that taxable year. (C. B. 4, page 100; A. R. R. 366.)

Stockholders of a corporation were advised of the decision of the board of directors to distribute a portion of the assets, the distribution to be made as of December —, 1915, and they were given until January —, 1916, to elect whether they would receive stock or cash.
Held, that there could be no constructive receipt until the option was exercised by the stockholders and communicated to the corporation. (C. B. 4, page 102; A. R. R. 375.)

An amount received by the lessee from the lessor of a living apartment, upon the termination of the lease, before its expiration for the purpose of defraying storage charges upon the lessee's household goods, should be included in gross income. (B. 37-21-1812; A. R. R. 617.)

The foregoing ruling is not sound. If the tenant had remained until the expiration of his lease there would have been no storage charges. The tenant was merely reimbursed for an expense incurred for the account of another. There is no legal or accounting precedent for calling such a receipt constructive income. The payment was authorized by the lessor and the amount of the expense, whether large or small, was of no more interest to the lessee than is the purpose of a cheque to the bank on which it is drawn.

The major element of constructive income is that it must be actual income; when it is taxable is another and far different question. Assume that two tenants were affected, neither of whom derived any advantage in the way of income or reduced expenses. If the storage charges paid by the lessor amounted to $500 for one tenant and $100 for another, with neither having the slightest interest in the cost, could constructive income of $500 be imputed to one and $100 to another? Since

neither derived any advantage the result to each must be the same. The lessor's expenses varied, but that concerns him—not the lessees. If the lessor had paid the moving expenses in consideration of moving ahead of time, the element of constructive income would arise. In a case dealing with a law partnership, where an attempt had been made to accrue fees from professional services, it was held:

Ruling. Numerous court decisions have been cited by the appellant in support of its contention that the rendition of a bill by a lawyer does not constitute a binding account receivable until the amount has been assented to by a client. It was further argued that the charges for legal services entered on its books were not determinable, and did not constitute income in the sense contemplated by the income tax laws. Further, that the charges were not "accounts receivable" as usually understood for the reason that no agreement existed between the principals fixing the amount of compensation for the services rendered.

In view of the foregoing facts the Committee is of the opinion that the method used by the appellant in determining its net income for the taxable year 1920 is not sufficiently definite to be construed as clearly reflecting the income of the firm, that the method used is not an accrual method in its acknowledged sense, and that the computation of net income for the year 1920 is more correctly determinable on the basis of cash receipts and disbursements. Further, that this conclusion is fully warranted under the provisions of section 212, Revenue Act of 1918, which empowers the Commissioner to make the computation on the basis and in such manner as in his opinion does clearly reflect the income.

It is therefore recommended, in the appeal of the M partnership that the action of the Income Tax Unit in denying permission to change from an accrual to a cash receipts basis in computing the net income of the firm for the taxable year 1920 be reversed and the appeal accordingly sustained. (I-3-29; A. R. R. 702.)

Book entries.—It is desirable, from many points of view, that income tax returns should agree with the books of the taxpayer; but the entries made on the books are not of fundamental importance when compared with the actual facts in a given situation.[22] The facts, not the book entries, control.[23]

[22] See Reg. 45, Art. 23, and T. D. 2873.

[23] Book entries, however, were required by the 1918 and earlier laws if deductions were claimed for bad debts. In the cases of both individuals and corporations, debts to be deductible must have been "ascertained to be worthless and charged off." (1918 law, section 214 (a-7).)

Foreign exchange.—

RATE OF EXCHANGE ON INCOME ACCRUING ABROAD.—

RULING. Income returnable for the purpose of Federal taxes should be expressed in terms of United States money. The rate of exchange at the time of receipt governs in making the computation. (C. B. 2, page 60; O. D. 419.)[24]

RULING. The Committee has reached the conclusion that under the abnormal conditions characterizing foreign exchange during the European war, the taxpayer may convert current assets less current liabilities payable in the foreign currency at the current rate of exchange or at any rate less favorable to him. The Commissioner should consider in any case applications to adopt a rate more favorable to the taxpayer or may on his own motion apply such a rate where the facts in the particular case warrant such departure.

This ruling should apply primarily to taxpayers trading or manufacturing in foreign countries and should not be held to apply to isolated or collateral investments in foreign credits or securities. (C. B. 2, page 60; A. R. R. 15.)

. . . . In the case of a domestic corporation engaged in business in a foreign country, its assets and liabilities (other than capital assets) recorded on its books in terms of the foreign currency, should be appraised in dollars (whether actually converted or not) at the close of each taxable year in which it is engaged in active business at the current or market rate of exchange, if any, then prevailing. (C. B. 2, pages 60-61; O. D. 489.)

A domestic corporation has a branch office in London which keeps a separate set of books in English currency and renders a report at the end of the year as to the profits. During the year, whenever the branch office has on hand more money than is needed for regular expenses, a remittance is made to the home office.

Held, that the net profits of the London branch for the year should be computed in English currency. From the total profits for the year should be subtracted the total amount remitted to the home office during the year, all expressed in English currency. To determine the equivalent of the profits in terms of United States money, the amounts remitted should be converted into United States money at the rate of exchange in effect at the date such remittances were made. The balance of the net profits, expressed in English currency, should be converted into United States money at the rate of exchange as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to the home office. (C. B. 2, page 61; O. D. 550.)

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[24] See also B. 42-21-1870; O. D. 1066.

Liquidation of indebtedness.—The Treasury has evolved a different procedure in cases in which liquidating liabilities to foreign creditors appear on the books in the United States, where remittances are made, not to cover specific invoices, but in a running account which remains open at the end of the year.

The rule laid down requires the averaging of the rate of exchange over the period, instead of applying specific rates to specific transactions or inventorying at the close of the period.[25]

The Treasury's position in regard to foreign items is not entirely clear but the rulings indicate that no attempt will be made to enforce arbitrary or unfair rules.

Capital items.—Fluctuations in exchange do not justify corresponding changes in the book values of capital assets or liabilities. The expenditure by a corporation of a million dollars for a building in New York is unchanged on the books, except for depreciation or obsolescence, even though the apparent market value declines one-half. If one million dollars is expended for a building in Paris when francs cost 8 cents and francs happen to be 6 cents at the end of the year, the apparent decline of $250,000 is not an allowable deduction. Capital profits and losses must be realized before they affect income tax computations.

Current items.—The author is of the opinion that current items, such as accounts receivable and accounts payable, bank balances, etc., should be inventoried when the books are closed, as nearly as possible on the basis of cost or market, whichever is lower.

Ruling. A corporation at the time of closing its books for the taxable year had an asset of x pounds sterling represented by advances made in cash to its London representative for the purchase of raw material in the London market. The purchases had not been made at the time of the closing of the books.

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[25] C. B. 3, page 75; O. D. 500.

The rate of exchange at the time of closing the books was lower than at the date the exchange was purchased.

Held, that the taxpayer did not sustain a loss as contemplated by the statute. . . . .

The item of "sterling owned" is a current asset. Under the ruling in C. B. 2, page 61 (see page 392), it should be inventoried at the rate of exchange in force at the end of the year. It may not be a technical loss, but if allowed as an inventory loss the net result is the same.

When current assets abroad exceed current liabilities and exchange is lower at the end of the year than during the year, a loss will be shown. When exchange is higher, no profit or loss will be shown.

When current liabilities exceed current assets and exchange is lower, no profit or loss will be shown. When exchange is higher a loss will be shown.

The rule is the same in case of one item of current asset or liability as it is in the case of branch houses.

The foregoing is merely conservative business practice and may or may not result in a saving of taxes. Based on market values, losses are taken, but profits are not anticipated.

Official rates of exchange.—During 1921, the Treasury has issued several rulings in which the rates of exchange at December 31, 1916, 1917, 1918, 1919 and 1920 which taxpayers should use have been summarized. These rulings will be found in bulletins as under:

C. B. 4, page 60;	O. D. 772
C. B. 4, page 60;	O. D. 803
C. B. 4, page 63;	O. D. 876
C. B. 4, page 63;	O. D. 898
C. B. 4, page 63;	O. D. 913
B. 34-21-1775;	O. D. 996
B. 37-21-1811;	O. D. 1027
B. 38-21-1826;	O. D. 1036
B. 40-21-1852;	O. D. 1052
B. 42-21-1869;	O. D. 1065
B. 51-21-1977;	O. D. 1137
B. 51-21-1978;	O. D. 1138

Community property.—The new type of income, that from "community" property, which first came into prominence as the result of an opinion of the Attorney General dated September 10, 1920,[26] has been defined at considerable length in a further opinion of the Attorney Gneral dated February 26, 1921,[27] quoted below. It is held that in Washington, Arizona, Idaho, New Mexico, Louisiana and Nevada, husband and wife may each report one-half of the income arising from community property under the laws of the respective states. Texas is also a community property state.[28] This privilege is held not to be applicable to California.

Rulings. Summarizing, it appears that in all of the community-property States except California their own courts have held that the wife has, during the existence of the marriage relation, a vested interest in one-half of the community property. Her rights in the property of the community are perhaps most fully recognized in the State of Washington, where both spouses have testamentary disposition over one-half of the community property, and where in the absence of such disposition it descends to their issue, or, in the absence of issue, to the survivor; while the husband is manager of the community estate in Washington he may not sell, convey, or encumber real estate unless the wife join with him in the conveyance; and as was held in *Huyvaerts* v. *Roedtz, ante, and Schramm* v. *Steele, ante*, the separate debt of the husband can not be satisfied out of community property where it is not incurred in connection with the community business, nor for the benefit of the community.

In Idaho it is seen that the limitation upon the alienation of the community real property is the same as in Washington. But while the wife's earnings and the rents and profits of her separate estate are community property she is given the management and control of same. The Idaho rule governing the disposition of community property on the death of either spouse is, with minor variations, the same as that of Washington. In neither State is an inheritance tax payable on the one-half of the community that goes to the one spouse on the death of the other.

In Arizona the husband only may dispose of community personal property, but the wife must join him in deeds or mortgages affecting real estate, except unpatented mining claims. One-half of the community property is subject to the testamentary disposition of either

[26] 32 Op. Att. Gen. 298; T. D. 3071.
[27] 32 Op. Att. Gen. 435; C. B.4, page 238; T. D. 3138.
[28] 32 Op. Att. Gen. 298; T. D. 3071.

spouse, and in absence of such disposition goes to his or her descendants; where there is neither testamentary disposition nor descendants, it is subject to distribution in the same manner as the separate property of the husband. On decree of divorce the court may divide the property as he sees fit, but in the absence of provision for the community property the parties from the date of the decree hold as tenants in common. The courts of Arizona hold that the wife is equal owner with her husband.

In Nevada, the husband has the entire management and control of the community property, except that the wife has entire control of her earnings when living separate from her husband. Upon her death the husband takes the whole community estate, except that where he has abandoned her without good cause she may by will dispose of half and in absence of such disposition it goes to her heirs, exclusive of her husband. On the death of the husband the wife takes half and the husband may dispose of the other half by will, or it goes to his surviving children; if there is no will and no children survive, the whole goes to the wife without administration, subject to certain provisos. On dissolution of community by divorce for any other ground than adultery or extreme cruelty, the community property must be equally divided between the parties. The wife pays no inheritance tax under the inheritance tax law of Nevada on her interest in community property, the courts holding that she takes not as heir but by a right vested in her at all times during marriage. It is to be noted that the constitution of Nevada recognizes the wife's interest in community property.

In New Mexico, while the husband is manager of the community estate, he may not transfer real property without a valuable consideration without the written consent of his wife; and under certain circumstances the wife may be substituted as manager; prior to 1915 he could not transfer community personal property except for a valuable consideration without her written consent; on dissolution of the community by the death of the wife the husband takes all except such portion as may have been set aside to the wife by judicial decree, which portion goes to her heirs unless she has disposed of same by will; on death of the husband one-half goes to the wife and the other half is subject to testamentary disposition by the husband. If he makes no will one-fourth of his one-half goes to the wife and the remainder to the children. On separation either may petition for division of community property and after divorce continue to hold as tenants in common where no disposition has been made in the divorce decree. New Mexico has no State inheritance tax act.

In Louisiana the community property comprehends all property acquired during the marriage by either husband or wife except that acquired with separate funds or by inheritance or particular donation, and excepting the earnings of the wife when she is living sepa-

rate from her husband; the husband is manager of the community but he may not convey community immovables by gratuitous title, and can not dispose of movables in fraud of the wife; either spouse may dispose of one-half the community property by will and the laws governing the descent of such property in the absence of testamentary disposition apply equally to both spouses, the survivor taking the deceased spouse's half by inheritance when there is no will, and neither father, mother, or descendants. As heretofore stated, the survivor pays no inheritance tax on his or her one-half of the community property but does pay on that part inherited from the deceased spouse.

In California the wife has no power of testamentary disposition of community property except of such as may have been set aside to her by judicial decree; she takes one-half as heir on the death of the husband; but on the death of the wife the entire community property belongs to the husband without administration. The California courts have held that under the law as it stood prior to 1917 the wife had no vested interest in community property prior to the dissolution of the marriage; the amendment to the inheritance tax act being limited to the purposes of that act could not have had the effect of vesting an interest in her, and had the addition of Sec. 172a had that effect any amendment of the inheritance tax act would have been unnecessary to exempt her one-half from taxation thereunder. In the case of *Blum* v. *Wardell*, now pending before the Circuit Court of Appeals of the Ninth Circuit, on appeal from the District Court of the Northern District of California, the application of the Federal Estate Tax Act of 1916 is under consideration.

As appears from my opinion of September 10, 1920, in Texas the control of community property is divided between the husband and wife; in that State on the death of either spouse without issue the survivor takes the whole and where there is issue, takes one-half, the other half going to said issue or their descendants. Under the State inheritance tax law the wife pays no tax on her half of the community property.

In *Warburton* v. *White*, 176 U. S. 484, 496, the principle was enunciated that where State decisions have interpreted State laws governing property or controlling relations that are essentially of a domestic and State nature the United States Supreme Court will follow the State decisions, if possible to do so, in the discharge of its duties. Also in *De Vaughn* v. *Hutchinson*, 165 U. S. 566, 570, it was held that to the law of the State in which property is situated we must look for the rules which govern its descent, alienation, and transfer, and for the effect and construction of wills and other conveyances. In *United States* v. *Crosby*, 7 Cranch 115, it was held that the title to land can be acquired and lost only in the manner prescribed by the law of the place where same is situated.

In arriving at an answer to the questions propounded by you we are called upon to determine the rules of property in the community property States; we have, therefore, pursuant to the rules of the above cases, adopted the rules laid down by the highest courts of the various States. There remains to be determined the application thereto of the income and estate tax provisions of Federal statutes. In my previous opinion it was stated that since in Texas the ownership in one-half of all community property vests in each spouse, whatever is income to the community is income to both. This conclusion applies, therefore, to all States in which community property is held to be vested equally in both spouses.

Section 201 of the Revenue Act of 1916 (39 Stat. 777) and section 401 of that of 1918 (40 Stat. 1096) impose a tax "upon the transfer of the net estate of every decedent" dying after the passage thereof, to be determined as is set forth in the sections following, which are:

Revenue Act of 1918.

SEC. 402. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

(a) To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate;

* * * * * * *

(d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have belonged to the decedent. (40 Stat. 1097.)

Subdivisions (a) and (c) of section 202 of the Revenue Act of 1916 are identical with subdivisions (a) and (d) of section 402 of the Revenue Act of 1918, quoted above.

While the community estate of husband and wife has not in the strictest sense all the incidents of a joint estate or an estate in the entirety as they were known at common law, I am convinced that the community estate is for all practical purposes within the language of subdivision (d) of section 402, there being deductible therefrom, in arriving at the net estate of decedent, the one-half interest of the surviving spouse, which may be shown to have originally belonged to such person, and never to have belonged to the decedent.

And even though it should be held that the community estate is not a "joint estate" or an "estate in the entirety" within the meaning of the Revenue Acts, the one-half interest of the deceased spouse in community property would still be subject to tax under the language of subdivision (a) above.

My answers to your questions are therefore:

(1) That in Washington, Arizona, Idaho, New Mexico, Louisiana, and Nevada the husband and wife domiciled therein, in rendering separate income tax returns, may each report as gross income one-half of the income which under the laws of the respective States becomes, simultaneously with its receipt, community property.

(2) In the States mentioned, in answer to question one, there should be included in gross estate, in computing the estate tax of a deceased spouse, one-half only of the community property of husband and wife domiciled therein.

(3) Neither of the above answers is based upon a statute enacted subsequent to March 1, 1913.

(4) My answers to these questions apply under income and estate tax Acts prior to the Revenue Act of 1918.[29]

A wife domiciled with her husband in the State of California may not report in her separate income tax return salary and wages received by her. (B. Digest 49-21-1964; O. D. 1128.)

In returns in which community income is divided between husband and wife domiciled in states where such income is divisible for income tax purposes, both husband and wife should report in detail the gross income from such community property. The deductions properly chargeable against such income should be equally divided between husband and wife. (C. B. 4, page 254; O. D. 909.)

Where a husband and wife, domiciled in a State other than a community property State, purchase lands located in Texas with the separate funds of one of the spouses, the rents and revenues therefrom constitute the income of the spouse whose funds purchased the land, and are so returnable. Where a husband and wife, domiciled in a State other than a community property State, purchase land located in the State of Texas with funds furnished in part by the husband and in part by the wife, the rents and revenues are income of each in proportion to their interest in the land and are so returnable. (B. 28-21-1727; O. D. 975.)

While domiciled in the State of Washington, husband and wife acquired real property therein with community earnings. Subsequent thereto they moved to another State, where they have since lived.

Under the laws of Washington the income from such property is community property. During coverture, as well as upon dissolution of the marriage, the wife has a vested and definite interest and title in the community property equal in all respects to that of the husband. Such interest is not affected by a change of domicile. Therefore, the husband and wife may file separate returns in which the

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[29] Summary of Opinion of Attorney General, published as T. D. 3138. For full decision, see C. B. 4, page 238; 32 Op. Atty. Gen. 435, 458.

income from community property in the State of Washington is divided between them. (B. 47-21-1933; O. D. 1110.)[30]

INTEREST AND PENALTIES ON AMENDED RETURNS UNDER T. D. 3071. —

RULING. Inquiry is made with respect to the assessment of interest and penalties in cases where amended returns are filed in accordance with the provisions of Treasury Decision 3071, relating to income from community property in the State of Texas.

Held, that no penalties for the understatement of tax may be assessed against the husband when the tax reported in his original return was as large as the tax actually due from him after the allocation of community income to each spouse upon the basis of separate returns. The Attorney General has held "that community property, under the laws of Texas, belongs to the husband and wife" and that "the income therefrom accrues to the husband and wife in equal shares." (T. D. 3071, C. B. 3, p. 221.) The husband, therefore, in reporting more than one-half of the community income in his return (not a joint return for himself and wife) was to that extent reporting income which technically was not *his* at all. Penalties are provided for the understatement of an individual's tax, as computed upon the total net income reported by him, and it is immaterial that the income from one or more sources is carelessly or intentionally understated in his return if by reason of an overstatement of income from other sources no understatement of his total net income is actually made. Therefore, in cases where the wife's share of community income, which was reported by the husband, was equal to or more than the amount of income received but not reported by him, there was no understatement of the amount of the husband's total net income and accordingly no negligence or fraud penalty could be assessed against him. Neither should a delinquency penalty be assessed against the wife in cases where her income, over and above her share of the community income reported by her husband, was insufficient to have required her to file a return prior to the issuance of Treasury Decision 3071, and in case she did file a return prior to the issuance of that Treasury decision, she should not be penalized for not reporting her share of the community income which she had reason to believe was reported by her husband. (I-1-13; I. T. 1154.)

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[30] For a similar ruling regarding a removal from Idaho to California, see B. 39-21-1845; Sol. Op. 121.

CHAPTER XIV

INCOME FROM PERSONAL SERVICES

Following the plan of subdividing the items of income into convenient groups, adopting generally the order and classification used in the statute, this chapter is devoted to income from personal services. This term includes not only salaries and wages but also fees received from professions or vocations.

Distributions by personal service corporations are dealt with elsewhere,[1] because the earnings of personal service corporations as defined in the act are not necessarily of the nature of services as the word "services" is usually understood. Salaries, however, of officers or other employees of personal service corporations are dealt with here.

LAW. Section 213. . . . . (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations,[2] . . . .

Compensation of Certain Officers Exempt

Salaries of the President and United States judges.—The omission in the 1918 law (the 1921 law is the same) of the

[1] See Chapter XXIV.

[2] **[Former Procedure]** The language of the 1917 law is the same as the 1913 law except for an immaterial change in the first phrase of section 4. In 1917, those who received incomes in the form of salaries, compensation for services, including all professional fees, commissions, and income in general from an occupation, vocation, profession or from a business with no capital or only nominal capital were compelled to pay, in addition to their income tax, a tax of 8 per cent upon the income from such sources. In other words, if anyone received an earned income of any kind in excess of $6,000 which had not been subject to the excess profits tax, he was subject to this 8 per cent tax. No tax of this kind appears in the 1918 or 1921 laws.

specific exemption formerly granted[3] to the President and United States judges raised the interesting question as to whether or not the salaries of these officers (whose compensation is not supposed to be diminished during their terms of office[4]) may be subjected to a federal income tax.

This question was decided in a recent case,[5] the Supreme Court holding that ". . . . the fathers of the Constitution intended to prohibit diminution by taxation as well as otherwise— . . . they regarded the independence of the judges as of far greater importance than any revenue that could come from taxing their salaries. . . . the tax was imposed contrary to the constitional prohibition, and must be adjudged invalid."

The (acting) Attorney General in an opinion rendered on June 21, 1920 (32 Op. Att. Gen. 248) stated, in part: "I am unable to see, therefore, that there is anything in the recent opinion of the Supreme Court [*Evans v. Gore, supra.*] which relieves a judge appointed since the enactment of the income tax law from paying the tax imposed by that law."

REGULATION. . . . . The salaries of Federal officers and employees are subject to tax, except that, in view of the provisions of the Constitution of the United States as construed by the Supreme Court, the salaries of the President of the United States and Federal judges are not subject to a new tax or an increased tax if elected or appointed to office prior to the passage of the taxing statute. The Revenue Act of 1921, however, imposes no new or increased tax upon such salaries; hence the salaries of all Federal judges appointed

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[3] [Former Procedure] The 1917, 1916, and 1913 laws contained the following exemption:

LAW. Section 4. The following income shall be exempt from the provisions of this title: . . . . the compensation of the present President of the United States during the term for which he has been elected, and the judges of the Supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a state, or any political subdivision thereof, except when such compensation is paid by the United States government.

[4] Attorney General Hoar, 13 Op. Att. Gen. 161 (1869). See also *Pollock v. Farmers' Loan and Trust Co.*, 157 U. S. 429, 39 L. Ed. 759; 15 S. Ct. 718; 158 U. S. 601, 39 L. Ed. 1108, 15 S. Ct. 912.

[5] *Evans v. Gore,* 253 U. S. 245, 40 S. Ct. 550, 64 L. Ed. 887.

since February 24, 1919, are subject to the tax imposed by the Revenue Act of 1921. . . . . (Art. 32.)

Compensation of federal officers in general not exempt.—Only those federal salaries which were specifically designated as not subject to the income tax were exempt under laws prior to 1918. All other federal employees, except as noted below, were taxable under former laws and are taxable under the 1921 law.

COMPENSATION OF REFEREES IN BANKRUPTCY.—

RULING. The decision of the United States Supreme Court in *Evans v. Gore* (T. D. 3037), relative to the taxability of salaries of judges of the Supreme Court and inferior courts of the United States, is not applicable to referees in bankruptcy as they are not judges of inferior courts. The fees received by referees in bankruptcy are subject to tax under the provisions of section 213(a) of the Revenue Act of 1918. (C. B. 3, page 104; O. D. 678.)

COMPENSATION OF JUDGES OF TERRITORIAL COURTS.—

RULING. Judges of territorial courts are not such judges as are referred to in article III of the Constitution whose salaries are exempt from income tax in accordance with the decision of the Supreme Court of the United States in *Evans v. Gore*. (C. B. 4, page 83; O. D. 899.)

MEMBERS OF BOARD OF UNITED STATES GENERAL APPRAISERS.—

RULING. The Board of United States General Appraisers is not a court nor are its members Federal judges. Therefore, salaries paid the members are not exempt from tax under the Revenue Act of 1918. (C. B. 4, page 83; O. D. 902.)

Salaries of state officers and employees exempt.[6]—As a result of judicial interpretation of the scope of the federal taxing power, an implied limitation has been placed upon the power of Congress, prohibiting it from taxing the salaries of state officers.[7] But there has been no interpretation of that power since the passage of the sixteenth amendment. The

[6] **[Former Procedure]** The laws of 1913, 1916 and 1917 exempted such compensation.

[7] *Collector v. Day,* 11 Wall. 113, 78 U. S. 113, 20 L. Ed. 122.

idea of abandoning this doctrine has therefore found considerable support. If the war had continued, it is probable that the employees formerly specifically exempted would have been specifically taxed. The 1918 bill as it passed the House of Representatives so provided. Senator Simmons, in reporting to the Senate the law as it now stands, said: "The Committee amended section 213 (a) so as to require that any . . . . salaries paid be subject to the income tax, leaving the Constitutional question as to the authority of Congress to tax certain salaries to be settled by the courts in any case in which the question may be raised."[8]

The attitude of the Treasury under the 1918 law, the language of which is re-enacted in the 1921 law, is based on an opinion of the Attorney General (31 Op. Att. Gen.—) and is expressed in the following regulation and decision:

Ruling. . . . . In accordance with an opinion of the Attorney-General, dated May 6, 1919, and based on the well-settled rule that governmental agencies of the states are not subject to taxation by the federal government, it is held that salaries of state officials and salaries and wages of employees of a state are not subject to the income tax imposed by the said Revenue Act of 1918. (T. D. 2843, dated May 17, 1919.)

Regulation. Compensation paid its officers and employees by a state or political subdivision thereof, including fees received by notaries public commissioned by states and the commissions of receivers appointed by state courts, is not taxable. . . . . (Art. 88; Reg. 45, Art. 85.)

The issue is essentially constitutional—not administrative—and the matter cannot be deemed to be definitely settled until the courts have passed upon it. In view of the Treasury's position, however, it is difficult to see how the question will be litigated.

Since the 1918 provision has been re-enacted into the 1921 law, the Treasury should proceed to collect taxes from state officers and employees. The question would then be settled by the United States Supreme Court.

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[8]Report of Finance Committee to Senate, December 6, 1918, page 6.

DEFINITION OF "OFFICER" AND "EMPLOYEE."—

RULING. An officer is a person who occupies a position in the service of the Government, the tenure of which is continuous and not temporary, and the duties of which are established by law or regulations and not by agreement.

An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary. (Digest 45-21-1906; A. R. R. 664; Sol. Op. 122.)

COMPENSATION OF REFEREE—APPOINTED BY JUDGE OF STATE JUDICIAL DISTRICT.—

RULING. A referee in drainage is appointed by the district judge of the State judicial district in which the drainage project is located. The judge is vested with authority to provide for the payment of the referee's salary, to regulate his duties, and to discharge him at pleasure.

Held, that the referee is an employee of a political subdivision of the State and that his salary as such is not subject to tax under the Revenue Act of 1918. (C. B. 2, page 100; O. D. 525.)

COMPENSATION OF RECEIVER—PARTLY STATE, PARTLY FEDERAL.—

RULING. A receiver was appointed by a State court for the assets of a corporation, a part of which were located in the State appointing the receiver and the remainder in another State. The Federal district court for the latter State appointed the same person as receiver for the assets located in that State. The fees arising from the receivership are allowed in a lump sum, such compensation being fixed by the State court and approved by the Federal court.

Held, that the exemption from taxation as compensation of a State employee applies only to that portion of the fee which is attributable to the appointment by the State court; the portion attributable to the appointment by the Federal court should be reported as taxable income by the recipient. The court fixing the compensation should be requested to allocate the portions reasonably attributable to the State and Federal appointments. (C. B. 2, page 99; O. D. 503.)

COMPENSATION OF ENGINEERS HAVING CONTRACT WITH STATE.—

RULING. A partnership of civil engineers has a contract with an irrigation district of a State for a period of two years as consulting and supervising engineers on any question it may be called on to

consider in connection with development work of the district. At the same time it accepts business from the public generally.

Compensation received by the firm from this source is not exempt from taxation as compensation paid its employees by a political subdivision of a State. (C. B. 2, page 100; O. D. 545.)

The ruling was based on the following definition of employee which appeared in the detailed decision:

The term employee is ordinarily understood to mean one who is in the regular and continual service of his employer and who is subject to the direction and control of the employer, the relation between the employer and employee (as in the relation between master and servant), implying that the employer not only prescribes to the employee the end of his work, but directs or at any moment may direct the means also, or retain the power of controlling the work.

This is a comprehensive definition and should enable one to determine whether he could be considered an "employee of a state" or not.

In the following case, however, it is to be assumed that the engineer was an "employee" as defined above.

Ruling. A chief engineer appointed by a sewerage commission created by the common council of a city under authority of a State statute, is considered to be an employee of a political subdivision of a State and the compensation paid him is not taxable. (C. B. 1, page 96; O. D. 309.)

Assistants to clerks of state courts—federal duties.—

Ruling. Where clerks of State courts employ clerical assistants in connection with the administration of the Federal naturalization laws and pay the salaries of such assistants out of fees collected by them, which fees are made available for that purpose by congressional appropriation, the compensation received by the assistants is income subject to tax under the provisions of the Federal income tax laws. Clerical assistants so employed are not State employees by virtue of such employment. (C. B. 2, page 99; O. D. 484.)

Employees of railway disbursing funds paid by county.—

Ruling. In constructing a causeway, the salaries received by the individuals employed thereon are paid from the funds of three railway companies and a county, which is part owner of the project. The

county pays its pro rata share of the salaries to one of the railway companies, which by its check pays the gross amount of the salaries.

Held, that as the employees constructing the causeway are not employed by and are not under the direction or control of the State or any political subdivision thereof, they do not come within the designations "State officers" or "Employees of a State" as used in article 85, of Regulations 45, and, therefore, their compensation is not exempt from income tax. (C. B. 2, page 101; O. D. 553.)

School officer—when not state employee.—

Ruling. Compensation received by individuals holding the positions of "State agent of normal schools for whites," "State agent of normal schools for negroes," and "high school inspector," which positions were created by the superintendent of public instruction of a State without statutory authority, is not exempt from tax as compensation received from a State or a political subdivision thereof, when such compensation is paid from an endowment fund no part of which is under State control. (C. B. 2, page 98; O. D. 449.)

Notary's fees exempt.—

Ruling. A partner who turned over to the partnership the fees received by him as notary public under commission from the State, may in computing his distributive share of the partnership income exclude from his return an amount equal to the fees so received and turned over to the firm. The other partners are not entitled to any part of the exemption, however, and must report their entire distributive shares of the partnership income regardless of the fact that a portion of it was derived from notarial fees received by one of the partners. (C. B. 3, page 125; O. D. 648.)

Compensation of executors and administrators not exempt.—

Ruling. An individual who exercises a public function under an appointment issued by a court officer for a particular transaction or purpose for a limited time, and in the exercise of such function is not invested with the character of either an officer or employee of the State or political subdivision thereof, is not considered to be such a State official or employee whose compensation is exempt from Federal income tax under the provisions of article 85 of Regulations 45 and Treasury Decision 2843.

The designations "State officers" and "employees of a State" refer only to those persons who are in the regular and continual service of the State or a political subdivision thereof within the ordinary acceptance of these terms. Accordingly, administrators and executors, whether or not they are considered to be officers of the court in the performance of their duties, are not exempt from Federal in-

come tax on the compensation received for their services. (C. B. 1, page 96; O. D. 256.)

COMPENSATION OF LIQUIDATING TRUSTEES NOT EXEMPT.—

RULING. The compensation paid trustees of a corporation, who have filed an application for winding up the affairs of said corporation in accordance with the laws of the State of Connecticut, is not exempt from income tax, as the trustees are not receivers in fact and do not appear to exercise a public function under an appointment of the court, nor are they invested with the character of an officer or employee of the State, although the compensation is fixed by the court. (C. B. 2, page 98; O. D. 369.)

SPECIAL COUNSEL TO CITY IS NOT AN OFFICER OR EMPLOYEE.—

RULING. A counsellor at law is engaged by a municipality as special counsel, to act in connection with the regular city attorney in handling a certain piece of litigation. Is he regarded as an officer or employee of a political subdivision of a state, so that his compensation for his services is not taxable under article 71 of Regulations 45, sentence 2 [now Art. 85]?

(Answer.) In reply to the first question, you are advised that under the ruling of this office, the compensation paid by a state to "special counsel," such as described above, is taxable income, and not exempt from income tax. (Part of letter from Collins & Corbin, Jersey City, N. J., and the answer thereto, signed by J. H. Callan, Assistant to the Commissioner, and dated April 15, 1919.)

SPECIAL COUNSEL FOR STATE COMPTROLLER—COMMISSIONS EXEMPT.—

RULING. The New York transfer (inheritance) tax law provides for the appointment of an attorney in each county to look after the State's interests in the collection of inheritance taxes. In 1914 A was appointed by the State comptroller as attorney in a certain county and has since then continued in that position. He receives as compensation a commission upon the transfer of most of the estates; in other cases he is paid such fees and allowances as the comptroller decides are reasonable and proper. It is stated that in the service of all papers upon him relating to transfer-tax proceedings, service is recognized as being upon the comptroller and further that all of his official acts are representative of the comptroller, being so recognized by the courts.

Held, that the compensation received by A in the capacity of attorney for the State comptroller is not subject to Federal income tax under the provisions of article 85 of Regulations 45. (C. B. 2, page 99; O. D. 494.)

It is difficult to see any essential difference between the two cases above, the compensation the attorneys receive being in fact received from a state or political subdivision thereof.

Compensation of National Guard exempt—when?—

Ruling. The compensation paid by a State to an officer of the National Guard of the State is exempt from the taxes imposed by the Revenue Act of 1918.

The compensation paid by the Federal Government to an officer of the National Guard for services while engaged in field training or at instruction camps is not exempt. (C. B. 4, page 112; O. D. 942.)

Confederate state pensions not exempt.—

Ruling. Pensions paid by the State of Kentucky to Confederate Civil War veterans are not exempt from tax under the Revenue Act of 1918. These veterans can not be said to be "officers" or "employees" of a State within the ordinary and usual meaning of those words. (C. B. 4, page 112; O. D. 903.)

Attorneys employed by state exempt—when?—

Ruling. The certified copy of the order of the court approving the employment of A, an attorney at law, by the collector of revenues in a certain county, states that the employment is for the term of office of the collector; that is, for a period of four years. The taxpayer states that this has been the practice for many years.

A State statute provides that the collector may employ such attorneys as he may deem necessary to file such suits as may be required for the collection of delinquent taxes. . . . .

Since the collector is responsible for the institution and prosecution of such actions and has a right to employ such attorneys for such purposes as he may deem necessary, he would have the right to discharge any attorney for failure to carry out his instructions. The employment of the attorney consists in the agreement to render personal services as directed by the collector. The relation of employer and employee exists. It is therefore the opinion of this office that the taxpayer is an employee of the county and that his compensation received as such is exempt from the income tax. (B. 46-21-1919; O. D. 1099.)

Pilots employed by a state commission held not exempt.—

Ruling. A taxpayer is a pilot for a port in the State of Florida, appointed by the Board of Pilot Commissioners after qualifying by required examination. This board is appointed by the Governor of

the State of Florida. The taxpayer claims his compensation as pilot is exempt from tax as compensation paid an officer or employee of a State.

Held, that inasmuch as the taxpayer receives his compensation as pilot from fees paid by the steamship companies to the Board of Pilot Commissioners, rather than from funds of the State, such compensation is not exempt from the tax imposed by the Revenue Act of 1918. (C. B. 4, page 112; O. D. 916.)

District of Columbia, territories, etc., are not "states."—The 1917 law (section 23) declares that "nothing in this title shall be held to exclude from the computation of net income the compensation paid any official by the governments of the District of Columbia, Porto Rico, and the Philippine Islands, or the political subdivisions thereof." No definite ruling appears to have been made regarding the status of territories, but apparently the former exemption extended to state employees did not extend to the employees of territories.

Ruling. Compensation of teachers of the Territory of Hawaii is subject to income tax under section 213 (a). (C. B. 1, page 66; O. D. 12.)

Pay of soldiers and sailors.—The special exemption for soldiers and sailors which appeared in the 1918 law is not re-enacted in the 1921 act.[9]

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[9] **[Former Procedure]** The 918 law reads as follows:

Law. Section 213. ". . . . 'gross income'— . . . . (b) Does not include the following items, which shall be exempt . . . .

(8) So much of the amount received during the present war by a person in the military or naval forces of the United States as salary or compensation in any form from the United States for active services in such forces, as does not exceed $3,500. . . . ."

Supplementing the above section of the law, the regulations provided:

Regulation. ". . . . this exemption does not apply to compensation received either before or after the present war. The date of the termination of the war for the purpose of the statute will be fixed by proclamation of the President. The military and naval forces of the United States include, among others, army contract surgeons and the individuals named in section 1 of the statute. A person is in active service if he is actually serving in such forces, not necessarily in the field or in the theatre of war, and is not merely on the retired or reserve list. Accordingly, if such a person receives compensation from the United States of $3,500 or less and has no other

The Treasury has held (C. B. 4, page 112; O. D. 900) that for the purpose of this section of the law the war terminated March 3, 1921.

RULING. The following items are to be included in the $3,500 exemption provided in section 213 (b) 8, Revenue Act of 1918, for salary or compensation received by persons in the military or naval forces of the United States during the "present war":

Bonus payable upon discharge.

Mileage from point of discharge to point of enlistment.

Ration money covering periods of absence from camp on furlough. (C. B. 2, page 101; O. D. 370.)

Pensions and all payments under war risk or vocational rehabilitational act are exempt.—

LAW. Section 213. . . . . **(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .**

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts,[10] or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war; . . . .

Pensions received from a state have also been held to be exempt.[11]

Contractor for public work not a public employee.—

REGULATION. Any profit received from a State or political subdivision thereof by an independent contractor is taxable income. Where warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If for any reason the contractor upon conversion of the warrants into cash does not receive and can not recover the full value of the warrants so returned, he may allowably deduct from gross income for the year in which the warrants are converted into cash any loss sustained, and if he realizes more than the value

income of an amount sufficient in itself to require him to render a return of income, he need make no return. Members of draft boards are not as such entitled to this exemption." (Reg. 45, Art. 86.)

[10] **[Former Procedure]** Under the 1918 law payments under this act were taxable. Pensions were also taxable under the 1918 law. (C. B. 4, page 79; Sol. Op. 97.)

[11] C. B. 2, page 98; O. D. 434.

of the warrants so returned he should include such amount in his gross income of the year in which realized. (Art. 37.)

If a contractor accepts payment in warrants which are selling in the market at less than par he need not account for the amount received at any value above the market. If the contractor collects the warrants at par he will be accountable for the excess when received. If sold for more or less than their market value when received, adjustment would have to be made at time of sale.

Income from jury fees.—Fees paid to jurors serving in United States courts are taxable income. Fees paid by states are not taxable.

Mileage paid to jurors should be applied against expenses paid. If there is a surplus it is taxable, if a deficit it should be deducted from the fees as a necessary expense incident to the earning of the income.

RULING. . . . . Persons serving on the jury of a State, county, or municipal court are held to be employees of a State or a political subdivision thereof, and fees and compensation received by them are accordingly exempt from tax. (C. B. 1, page 98; O. D. 434.)

Fees of witnesses summoned by a state attorney are held to be taxable.[12]

Salaries in "land-grant" colleges.—Through acts passed in 1862, 1890 and 1914, the last known as the Smith-Lever Act, Congress deeded certain lands and granted certain funds to the states for the support of colleges. The taxability of the salaries of the professors in such colleges turns upon the point as to whether or not these teachers are employees of the state. If they are, their salaries are not taxable[13] even though they are received in whole or in part from Smith-Lever funds, for such funds "lose their identity as funds of the United States by being paid to the states."[14]

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[12] C. B. 1, page 67; O. D. 195.
[13] With regard to their possible tax liability under the 1918 and 1921 laws, see page 403.
[14] T. D. 2668, March 9, 1918.

REGULATION. . . . . Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a State, are not required to return as taxable incomes the salaries so received. This is also true with respect to the Act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the Act of March 2, 1887, relating to agricultural experiment stations in such colleges. (Art. 88; Reg. 45, Art. 85.)

Salaries of civil service employees.—

RULINGS. The amounts deducted and withheld from the basic salary, pay, or compensation paid to employees in the civil service of the United States, in accordance with the provisions of the Act approved May 22, 1920, should be reported by such employees for income tax purposes. The total compensation of the employees should be reported in gross income and no corresponding deduction can be taken for the amounts withheld, inasmuch as such amounts are payments made toward the purchase of annuities provided for in the Act and are not allowable deductions for income tax purposes.

The annuities paid to retired employees are subject to tax to the extent that the aggregate amount of the payments exceeds the amounts withheld from the compensation of the employees. (C. B. 1, page 76; T. D. 3112.)

If an employee leaves the civil service of the United States before he is eligible to retirement under the Act of May 22, 1920, and receives the amount of salary withheld, together with interest, he should report only the amount of interest received by him as income for the year in which received. (C. B. 4, page 77; O. D. 823.)

Accounting Procedure

Receipt or accrual method.—Salaries and wages need not be accounted for in the return until payment is made and received.[15] Unquestionably this is the most convenient method of dealing with salaries and wages, because comparatively few recipients of incomes of this nature keep books, and it would require some adjustments of accounts to report the salary earned within a calendar year but partly paid prior or subsequent thereto. But anyone desiring to keep books on an accrual basis (that is, entering all income as earned and all

[15] See Chapter XXVI as to deductions of compensation for personal services in carrying on a trade or business.

expenses as incurred) is permitted and encouraged to do so. For a full discussion of the accrual method, see page 383. If any part of the accrued income so reported becomes uncollectible, the regulations permit credit to be taken therefor as an allowable deduction.

The so-called receipt method cannot be used if it serves to obscure the taxpayer's actual net income for the taxable period. Section 212 (b) defines "net income" and states that "if the method [of accounting] employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

If the taxpayer prefers to prepare his income tax return from his cheque book or cash book, no fault will be found, if the result clearly reflects his actual net income. In such cases it is suggested that if the taxpayer's income arises from fees, etc., a cash book with several columns will be most useful. On the receipt side all items of receipts from fees, etc., should be entered in a column reserved for the particular purpose, so that at the end of the year the aggregate of such column will be the proper amount to include in the return. If at all feasible, however, the accrual system should be adopted. No other method accurately reflects net income, except in the case of wage-earners who have no investments.

REGULATION. Where no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis, or, for the taxable year in which received, if the return is rendered on a receipts and disbursements basis. . . . . (Art. 32.)

Many professional men, when closing their books for their taxable years, enter as accrued income an estimate of what has been earned to such date, and report such estimate as taxable income. This they have a right to do under the law.

RULING. A performed certain services in 1909 under an agreement that he was to receive as compensation a percentage of the net income of a business enterprise, the time of payment, however,

to be within the discretion of the individuals in control of the business enterprise. The amount of A's compensation was determined in 1916 but not paid until 1919. Held that as A kept his books on the cash receipts and disbursements basis, the entire amount received constitutes income for the year 1919. (C. B. 2, page 85; O. D. 460.)

In this case the business was disposed of in 1916, and A could not have earned the compensation after that time. It might also be said that on the principle of "constructive receipt" he received the compensation in 1916. Certainly A could not be taxed on any income which had accrued to him at March 1, 1913.[16]

RULING. A taxpayer who keeps no books of account, and to whom is paid, upon the termination of services extending over a period of years, a lump sum in amount not previously agreed upon, as compensation for such services, must return as income in the year in which received the entire amount so paid him, even when such payment is accompanied by a statement proportioning the compensation over the years in which the services were rendered. (C. B. 2, page 80; T. D. 2960.)[17]

In the foregoing case the service did not begin until May 27, 1913.

The following court decision is also of interest.[18]

DECISION. (Syl.). . . . . Where, relying on the unofficial promises of a majority of the board of directors that additional salary would be voted him for past years, the president of a corporation overdrew his account with the corporation, additional salary, subsequently voted, was income to him for the year in which the amount thereof was finally settled upon and segregated by an order of the board, although he had actually received and spent the money, as overdrafts, prior to that year.

This procedure, as well as the principle laid down in the Jackson case, works an injustice to the taxpayer.

If the Supreme Court adopts the principle that income cannot be taxed unless and until it is realized in cash, or the

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[16] See page 377. See also Art. 90, page 417; and C. B. 4, page 83; O. D. 956.

[17] This statement was issued with an extract of the decision in the case of *Jackson v. Smietanka*, 267 Fed. 932. The Circuit Court of Appeals for the Seventh Circuit has recently affirmed this decision (272 Fed. 970).

[18] *Holbrook v. Moore*, United States District Court, February 8, 1921 (not reported). See T. D. 3161.

equivalent of cash, the Treasury will have to recede from its position in Regulations 45 and many rulings. Its former principles, however, regarding uncertain and undetermined claims, resulting in realizations in later years have been overruled in Regulations 62.[19]

"BACK PAY" AWARDED BY RAILROAD BOARD TAXABLE IN YEAR OF RECEIPT.—

RULING. A taxpayer who had been discharged from the employ of a railroad company was reinstated by order of the Railroad Board and paid for all time lost during a period of over two years. It is contended that the sum received by the taxpayer, for which he rendered no service, is in reality a gift and not taxable.

Held, that the payment can not be treated as a gift for the reason that it was not made voluntarily. It is income within the ordinary acceptation of the word and not being such income as is expressly exempt under the Act, should be included in the return of the taxpayer for the year in which it was received by him. (C. B. 2, page 71; O. D. 512.)

Compensation of trustee taxable when received.—

REGULATION. If no determination was made as to the amount due the trustee of an estate as compensation for his services over a period of years until the trust was terminated, the amount allowed him should be returned in full, subject to allowable deductions, as income for the year in which paid; and should not be prorated over the length of time during which he served as trustee. (T. D. 2135, January 23, 1915.)

The question here arises as to what constitutes a "determination." This ruling, of course, would not be applicable if it could be shown that a definite, or an approximately definite, portion of the fee had been earned and had accrued prior to March 1, 1913. The trustee could not legally be taxed on income which accrued prior to the date when the law went into effect.[20]

Otherwise the ruling is fair, because the trustee could have reported the accruing income annually. If he did not

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[19] See page 532.
[20] See page 377.

do so and was compelled to return a large amount in a year when there was in force a tax rate higher than during the years when the income accrued, he had only himself to blame for not having adopted the accrual basis.

Compensation for services rendered before March 1, 1913—How far taxable.—

REGULATION. . . . . Where services were rendered prior to March 1, 1913, but paid for thereafter, the amount received is taxable income to the extent of the excess of such amount over the fair market value on March 1, 1913, of the principal of the claim and any interest which had then accrued. . . . . (Art. 90; Reg. 45, Art. 87.)

This is logical. The accrual before March 1, 1913, was not taxable, because in effect it became capital at that date. If it was found to be bad after that date, it was properly an allowable deduction. If the income accrued after March 1, 1913, and was not returned for taxation, it would be improper to claim the loss as a deduction.

Compensation for Services Distinguished from Gifts, Dividends, etc.

The establishment of a clear distinction between compensation for personal services, on the one hand, and gifts, distributions of profits or assets and payments for property, on the other, is one of the very difficult tasks in income tax procedure. In the case of bonuses, Christmas gifts, "profit-sharing" distributions, and other payments of a like nature, it is sometimes almost impossible to determine the exact extent to which they contain other elements than that of mere remuneration for services rendered. The Treasury has faced this problem squarely[21] and has issued regulations laying down the principles in accordance with which these distinctions

[21] The subject was first treated in a very inadequate fashion in Reg. 33, 1918, Art. 138. In T. D. 2696 (April 10, 1918) the subject was clearly and accurately presented.

are to be made. These regulations (articles 105-107) are quoted in full in Chapter XXVI.

Briefly it is held that "the test . . . . is whether they are reasonable and are in fact payments purely for services." Even though the payment is determined on a contingent basis and is greater than the amount which would ordinarily be paid, it may still be considered pure compensation if the basis is determined "pursuant to a free bargain between the enterprise and the individual made before the services are rendered . . . ." In case of compensation determined after services have been rendered, reasonableness is ordinarily the controlling test.[22]

The Treasury held, in the following case, that the payments made were for services which had been rendered and were not a gift:

RULING. A was an employee of the M Company under contract for a period of 21 years, such contract being terminable at the will of the company. The company sold its assets and discontinued business during 1920, and at the time A's employment ceased in 1921 he received 6y dollars from the M Company as an expression of its appreciation of his long and faithful service. A had no interest in the company, received nothing in the way of bonuses or extra commission, and had no agreement with the company for anything further than his salary.

This office has held that pensions and bonuses are in the nature of additional compensation to the recipient and must be included in computing net income. In a like manner, any lump sum received by an employee from a former employer upon the termination of his employment has in it a large element of compensation for services previously rendered.

It is held, therefore, that the amount received by A is in the nature of additional compensation and must be included by A in computing his net income for the year in which it was received. (B. 37-21-1814; O. D. 1814.)

In cases such as the above, the assumption is that the payments are for services, but if intended as a gift the recipient is not taxable thereon. The facts of the foregoing case are not stated in detail, but it appears that the payment was made

[22] See Chapter XXVI.

as an expression of the company's appreciation of the employee's long and faithful service. There would appear to be strong evidence to support a gift.

The following arrangement was held to constitute a gift:

Ruling. Subsequent to February 28, 1913, the M Company issued to A an endowment life insurance policy on his life. A made a single payment of $5x$ dollars in consideration of which the M Company agreed to pay as an endowment the sum of $6x$ dollars. The insured placed the policy on the accelerative endowment plan so that the policy became payable in 1920. It was agreed when the policy was written that the proceeds should be paid in two hundred and forty monthly payments, one-half of which should be paid to B, a son of the insured, and the remaining one-half to C, a daughter of the insured, provisions being made for payment in the event of the death of the beneficiaries named. The installments beginning with the —— were to be increased by such dividends as might be apportioned thereto. A is still living.

Held, that the endowment policy in question was a gift by A to B and C and that that part of each installment paid under the policy to B and C which represents a return of the capital value received by them, that is, the cost of the policy to the donor, is not taxable income, but that that part of each installment which represents the gain derived by them or dividends apportioned to the installment, should be returned as taxable income. (B. 47-21-1931; O. D. 1108.)

Gifts or bonuses to employees.—The interest of the recipient of a bonus or similar kind of income is centered upon the taxes which he may properly be called upon to pay on account of the item. If it is adjudged an expense, he is fully taxable upon the amount received, because the employer has not paid any tax on the sum. Certain employers, however, prefer to make these payments tax-free to the recipients and to treat them as distributions of profits. In some cases such payments were made in good faith and charged as expenses, only to be subsequently disallowed by income tax inspectors. Naturally the recipients, in reporting the amounts received, should not have had to pay again the tax which had been paid in their behalf.

The regulations prescribe in detail the procedure to be followed by the recipient of such income.

Commissions, fees and tips are taxable.—

Regulation. . . . . Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, ... are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist or religious worker for services rendered. . . . . (Art. 32.)

Christmas gifts, however, are not considered income within the meaning of the law and are not supposed to be included in a return,[23] but if deducted by employers as additional compensation (as is usually the case) the amounts received are taxable.

Ruling. Commissions advanced in payment for services of an advertising solicitor should be reported as gross income for the taxable year in which received. Any portion of the commissions thus received, which are paid back, owing to failure of payment for advertising, may be deducted as a loss for the year in which payments are returned. (C. B. 1, page 67; O. D. 19.)

The question arises as to the year in which the bonus should be reported. It is customary for many concerns to set apart bonuses at the end of the year and pay them a few days after the close of the year.

Ruling. In accordance with its annual practice, a company on December 31, 1916, set aside on its books a lump sum representing a part of its net profits for 1916 for the purpose of distributing the same to its employees as additional compensation for services rendered during that year. The actual disbursement of this fund was made on January 2, 1917.

Held, that this additional compensation was taxable in the hands of the recipient employees at 1917 rates, since the setting aside of the amount to be distributed on the company's books on December 31, 1916, was not a sufficient compliance with the regulations to warrant treating it as income constructively received in 1916. (C. B. 3, page 111; A. R. R. 182.)[24]

The Treasury also said in this case that "the amount set apart" was not subject to demand by the employees, and

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[23] T. D. 2090 (December 14, 1914).

[24] Issued under Revenue Act of 1917.

therefore in effect the bonus could not be said to be "constructively" received[25] in 1916.

Government pensions to widows are gifts.—

RULING. Held, that pensions paid by the United States Government to widows of soldiers, as such, are not taxable income for the reason that such pensions are not awarded as compensation for services rendered to the United States Government by the widows and are mere gifts or gratuities. (C. B. 4, page 84; O. D. 857.)

Remuneration to executor provided by will held taxable.— In the case of *United States v. Vanderbilt*,[26] the late Alfred G. Vanderbilt, by his will, bequeathed sums varying from $200,000 to $500,000 to men named by him as executors and trustees under his will in "lieu of all compensation or commissions" for their services as such. These executors and trustees claimed that these sums were bequests and therefore not taxable, and did not include them in their income tax returns. The Internal Revenue Bureau took the view that the entire sums were in payment for services, and therefore were taxable income. Suit was brought and the court sustained the view of the Bureau.

Compensation of the clergy.—

The Treasury has held that a pension paid to a retired clergyman is taxable income.

RULING. The fact that the pensions are paid through the governing body instead of by each individual church direct to the pensioners is immaterial, as the churches and the governing body are part of the same religious organization and the fund out of which the pensions are paid is contributed by the churches by whom the retired clergymen were formerly employed. (I-2-17; I. T. 1157.)

RULING. A clergyman is not liable for any income tax on the amount received by him during the year from the parish of which he is in charge, provided that he turns over to the religious order of which he is a member, all the money received in excess of his actual living expenses, on account of the vow of poverty which he has taken.

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[25] See page 387.
[26] 275 Fed. Advance Opinions, page 109.

Members of religious orders are subject to tax upon taxable income, if any, received by them individually, but are not subject to tax on income received by them merely as agents of the orders of which they are members. (C. B. 1, page 82; O. D. 119.)

RENTAL VALUE OF RESIDENCE OCCUPIED BY CLERGY IS NOT TAXABLE INCOME.—

LAW. Section 213. . . . . **the term "gross income"— . . . .**

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation; . . . .

This exemption appears for the first time in the 1921 law.

Should taxes be eliminated from profits in computing bonus?—In calculating the amount of tax to be paid by recipients of commissions, bonuses, etc., which are based upon the profits of a business or a department thereof, the question arises as to the obligation, if any, of such recipients to assume a share of the tax paid by the business. Payments of such commissions, etc., are expenses of the business and should be treated as such by deducting them from gross income before stating the net profits subject to excess profits and income taxes. It follows, therefore, that since the payments referred to are reported as allowable deductions, no tax of any kind has been paid thereon by the business, but the recipients must personally pay income taxes[27] on any amounts they may receive, subject, of course, to statutory exemptions, other income, etc. Obviously, then, in the absence of any specific agreement to the contrary, it would be unfair to the recipients to compute such commissions, etc., on the income of the business after deducting excess profits and income taxes.[28]

[27] **[Former Procedure]** For any part of the year 1917, the 8 per cent excess tax had also to be paid.

[28] Decision *Edgar W. S. Reeder v. G. Winthrop Coffin and Quincy A. Gillmore*, individually and as copartners, trading as Coffin & Gillmore, Court of Common Pleas No. 3 (Philadelphia), June Term, 1918, No. 3268 (not reported). Extract from opinion: McMichael, P. J., November 15, 1918.

"We have considered the question of deduction of income taxes before

This position is subject to modification in cases where there may be said to exist an understanding with an employee that federal income and excess profits taxes are to be deducted before ascertaining the amount available for distribution to an employee who is on a profit-sharing basis and to the partners or stockholders. If an employee were on a salary basis the full amount of the salary, no matter how large, would be paid to the employee without deduction for federal taxes. Many employees who change from a salary to a so-called profit-sharing basis contend that, as they are held responsible for their income taxes (and in 1917 for the 8 per cent excess profits tax), employers have no right to transfer to them any part of a burden which fortuitously has been laid solely or chiefly upon the employer. In claiming the amount paid to the employee as a deductible business expense, the employer may be said to assent to the position that the employee is not liable to a tax based on net income. In view of the very high income and other taxes imposed upon corporations in the years prior to 1922, the whole matter becomes one of expediency. Employers and employees should come to an understanding and amend existing contracts by adding a clause setting forth the agreement which may be reached. In any event it is incorrect to calculate the taxes which would be payable if the employee had no interest in the business, and then charge the employee with a proportion of such amount equal to the percentage of profits to which he is entitled. This method is sometimes followed, but it imposes upon the employee part of a tax which is not paid to the government.

If it is decided that the employee is to bear a proportionate share of federal taxes on the net income remaining after his compensation has been charged as an expense, it will be necessary to use a somewhat complicated formula for determining the amount of net income remaining after deducting from

allowing the plaintiff 5 per cent of the net profits as salary. We do not think this deduction should be made, as it is not in any way contemplated by the contract."

earnings the compensation due to the employee; because the compensation due cannot be determined until taxes are allowed for—and taxes cannot be allowed for until the compensation due to the employee is determined. The following illustrations set forth as simple a formula as can be devised for reading the desired result:

PROBLEM

The manager of a corporation is to receive 10 per cent of the net income after taxes. As the amount to be paid the manager is a proper deduction in calculating the taxes, it becomes necessary to ascertain a sum which when used as a deduction in calculating the taxes will be 10 per cent of the amount remaining for both himself and the corporation after taxes are paid by the corporation.

The following calculation is set forth in a way which will enable anyone with only an elementary knowledge of algebra to understand the solution of the problem.

Assuming the invested capital of the corporation in 1919 to be $500,000, and the income for 1919 $110,000, what is the manager's bonus?

Let x = manager's bonus

EXCESS PROFITS TAX:

Income		$110,000 — x		
Exemption:				
8% of Invested Capital	$40,000			
And	3,000	$ 43,000		
20% of Invested Capital, less Exemption		57,000	at 20%	$11,400
Over 20% of Invested Capital		10,000 — x	at 40%	$4,000 - \frac{40}{100}x$
		$110,000 — x		$\$15,400 - \frac{40}{100}x$

INCOME TAX:

Income		$\$110{,}000 - x$		
Exemption:				
Excess Profits Tax	$\$15{,}400 - \frac{40}{100}x$			
And	2,000	$-17{,}400 + \frac{40}{100}x$		
		$\$92{,}600 - \frac{60}{100}x$	at 10%	$9{,}260 - \frac{6}{100}x$
Total Taxes				$\$24{,}660 - \frac{46}{100}x$

Income	$\$110{,}000 - x$
Taxes	$-24{,}660 + \frac{46}{100}x$
Net Income for Corporation	$\$85{,}340 - \frac{54}{100}x$

As the manager is to receive 10 per cent of Profits, leaving 90 per cent for the corporation, his share is 1/9 of the net income of the corporation, hence:

$$9x = \$85{,}340 - \frac{54}{100}x$$

$$9\frac{54}{100}x = 85{,}340$$

$$954x = 8{,}534{,}000$$

$x = 8{,}945.49$ being manager's bonus

Proof

Income before manager's bonus and taxes		$110,000.00		
Less: Manager's bonus		8,945.49		
Income before Taxes		$101,054.51		
EXCESS PROFITS TAX:				
Exemption:				
8% of Invested Capital	$40,000			
And	3,000	$ 43,000.00		
20% of Invested Capital, less Exemption		57,000.00	at 20%	$11,400.00
Over 20% of Invested Capital		1,054.51	at 40%	421.80
		$101,054.51		$11,821.80
INCOME TAX:				
Income		$101,054.51		
Exemption:				
Excess Profits Tax	$11,821.80			
And	2,000.00	13,821.80		
		$ 87,232.71	at 10%	8,723.27
Total Taxes				$20,545.07
Income before Taxes		$101,054.51		
Taxes		20,545.07		
Net Income to Corporation		$ 80,509.44		

Summary

Manager's Share	$ 8,945.49	10%
Corporation's Share	80,509.44	90%
	$ 89,454.93	

In the following illustration, a knowledge of algebra is not necessary.[29]

METHOD OF CALCULATING FEDERAL TAXES AND BONUS WHEN BONUS IS BASED ON NET PROFITS AFTER DEDUCTING FEDERAL TAXES

Given: A corporation with an invested capital of $840,000 makes a profit of $470,000 before calculating taxes and has an agreement with its manager to pay him 10 per cent bonus on net profits after paying taxes. In this case the entire bonus comes out of the 40 per cent bracket. Taxes before applying bonus amount to $173,124.

The change in taxes as result of allowing bonus would be as follows:

Decrease in excess profits tax	40% of bonus
Decrease in normal tax	10% " "
Total decrease	50% " "
Increase in normal tax as result of decreased credit account less excess profits paid, 10% of 40%, or	4% " "
Net decrease in tax	46% " "

As result of decrease in taxes there is more profit in which the manager would participate to extent of 10 per cent, or 4.6 per cent of the bonus.

Calculation of Bonus

Profits before taxes	$470,000.00
Taxes—before applying bonus	173,124.00
Balance	$296,876.00
10% bonus on above	$ 29,687.60
4.6% of $29,687.60 =	1,365.63
4.6% of 1,365.63 =	62.82
4.6% of 62.82 =	2.89
4.6% of 2.89 =	.13
Total bonus	$31,119.07

CALCULATION OF TAX

Profits $470,000.00 less $31,119.07 = $438,880.93

20% Bracket

20% of invested capital	$168,000.00	
Excess profits credit 8% of invested capital plus $3,000	70,200.00	
20% tax on balance	$97,800.00	$19,560.00

[29] From *Journal of Accountancy*, September, 1920.

40% Bracket

Profit	$438,880.93	
20% on invested capital	168,000.00	
Balance taxable at 40%	$270,880.93	108,352.37
Total excess profits taxes		$127,912.37

Income Tax

Profit	$438,880.93	
Credits:		
Excess profits taxes plus $2,000	129,912.37	
Balance taxable at 10%	$308,968.56	30,896.86
Total tax		$158,809.23

Proof

Profit before tax and bonus	$470,000.00
Taxes	158,809.23
Balance	$311,190.77
10% bonus to manager	31,119.07

In case the bonus came out of the 20 per cent bracket the decrease in taxes would be 28 per cent and the additional bonus to manager would be 10 per cent of that amount, or 2.8 per cent of the bonus.

When the bonus comes out of the 40 per cent bracket the amount of bonus before figuring taxes plus 4.8217813 per cent of itself will give the final bonus.[30] If it comes out of 20 per cent bracket, use 2.880656 per cent.

In case part of the bonus comes out of the 40 per cent bracket and the balance out of 20 per cent bracket, the calculation would be as follows:

A corporation with an invested capital of $100,000 makes a profit of $21,000, and has agreed to pay its manager 10 per cent of net profits after calculating tax. The tax, before deducting bonus, would be $3,880.

Calculation of Bonus

Profit before bonus and taxes	$21,000.00
Tax before deducting bonus	3,880.00
Balance	$17,120.00
10% bonus on above	1,712.00

Before deducting bonus there was a profit of $1,000 in the 40 per cent bracket, but after deducting bonus the entire tax would

[30] This statement is erroneous. The sentence should read:

"When the bonus comes out of the 40 per cent bracket, the amount of bonus (after figuring taxes as though bonus were not an allowable deduction) plus 4.8217813 per cent of itself will give the final bonus."

fall in the 20 per cent bracket. The reduction in taxes as result of allowing the tentative bonus of $1,712 would be as follows:

46% of $1,000.00 in 40% bracket	$ 460.00
28% of $712.00 in 20% bracket	199.36
Total saving in taxes on first calculation of bonus	$ 659.36
Manager gets 10% of this amount	65.94
2.8% of $65.94	1.85
2.8% of $1.85	.05
Total additional bonus	$ 67.84
Tentative bonus	1,712.00
Total bonus	$1,779.84

The proof works out as illustrated in the first example.

Compensation "of Whatever Kind and in Whatever Form Paid"

The law specifies that compensation for personal services shall be reported as income even if received in some form other than cash. Taxable income is to include compensation "of whatever kind and in whatever form paid." The regulations governing the valuation of services not paid for in cash read as follows:

Regulation. Where services are paid for with something other than money, the fair market value, if readily realizable, of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. . . . . (Art. 33.)

Recision of salary contract.—

Ruling. A contract was entered into between A and the M Company, whereby the compensation of A for the year 1918, in addition to his salary, was fixed at a certain per cent of the net income from the business. This contract was later modified and a stated amount agreed upon as the maximum liability of the corporation, which sum was paid to A in 1919, in full settlement of the contract for 1918, and was reported by A in his income tax return for 1919. Owing to dissatisfaction on the part of some of the stockholders over the second contract, an agreement was reached whereby the money received by A thereunder in 1919 was returned to the company on March —, 1921, and all rights under the contract waived.

The contracts of employment were fully performed in 1919 when the amount agreed upon was paid by the company to A in full settlement of the contracts. As there can be no recision of an executed contract there was no obligation upon A to refund any of the money so received. The transfer of the amount to the company on March —, 1921, was purely a voluntary act on his part and for income tax purposes the amount transferred must be considered a gift. (B. 43-21-1882; O. D. 1073.)

A contract *can* be legally rescinded by mutual consent. It is not necessary to support this statement by legal decisions. It is established business practice. If the foregoing ruling was decided on that point alone, it is not good law.

Premiums paid by employer on group life insurance—not income to employee.—

REGULATION. . . . . Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are not income to the employees. . . . . (Art. 33.)

Prior to March 20, 1920, the Treasury held payments of this character to be additional income of the employee. The employer, however, may deduct such premiums paid as "ordinary and necessary expenses."[31]

Compensation received in the form of stock.—

REGULATION. . . . . Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. . . . . (Art. 33.)

The proper valuation of such stock is often a matter of considerable difficulty and its true worth for purposes of taxation in many cases is not the same as the sum shown on the books of the company.[32] When there is an actual market price for the stock such price is the proper one to use. The

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[31] Bulletin 12-20-793; O. 1014.

[32] [**Former Procedure**] The "actual value" of such stock charged on the books of the corporation as an expense was the basis used previously. (Reg. 33, Art. 139.)

problem is complicated when there is no market value because the stock is not bought and sold on an exchange or when the directors have placed an "optimistic" value upon the shares. In case the recipient of the stock is one of the directors and as such has been a party to a formal determination that the services performed were equal in value to the par value of the stock, he would have difficulty in discussing this valuation with a revenue agent. If he was not a party to the valuation placed upon the stock by the corporation he should return the stock at the value which in his best judgment represents its actual worth, which would also represent the cash value of his services. He would not be bound by a nominal quotation for the stock on an exchange or by sales prices which might not represent "fair" prices.

The principles followed by the Treasury in fixing the value to be placed on stock received in payment for services, when the value at the date of issuance is unknown, are stated in the following:

RULING. . . . . It being an entirely new venture, the market price for the stock at the time of the incorporation and the issuance of stock was not known. Shortly thereafter, the taxpayer, as a part of the agreement, proceeded to make a market for the stock. That is to say, he had it listed on the curb and arranged for bringing it to the attention of the public. For his services the taxpayer received in payment shares of the stock of the corporation and voting trust certificates (non-negotiable).

No stipulated cash value appears to have been placed on the taxpayer's services.

Where services are paid for in something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If stock of a corporation is received in payment for services rendered, such stock must be considered as equivalent to cash, providing it has any actual money value. It is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. (See art. 33 of Regulations 45.) To constitute taxable income, however, the value of the stock received must be so fixed as to be capable of measurement at the time of receipt. If its value can not be measured in terms of cash or money's worth, then it can not be considered income for income-tax purposes. (19-19-494.)

The value of stock which has no market price may be estimated by resort to the value of the assets capitalized and attendant circum-

stances which may affect the value of such assets. (*Goodwin* v. *Wilbur,* 104 Ill. App., 45; *Collins* v. *Denny,* 89 N. W., 1012; *Virginia* v. *West Virginia,* 238 U. S., 202.) In the case of inventions, their value is dependent upon proven utility or the likelihood of practical usefulness and therefore stock issued thereon will have a corresponding value. If an inventor should sell a recently patented invention to a manufacturer before its use has been tested, but simply upon its apparent usefulness, it may be said that the invention at that time is worth what is paid for it, because a price has been offered and paid. The measure of value is the price paid. (*Burke Hollow Coal Co.* v. *Lawson,* 151 S. W., 657; *Johnson-Brinkman Commission Co.* v. *Wabash R. Co.,* 64 Mo. App., 590.) Stock issued upon such invention would be worth the value of the invention, measured by the price which the manufacturer has paid for it.

Where the inventor himself forms a company and issues stock upon his invention and there are dealings in said stock at or within a reasonable time after the issuance thereof, prices then paid may be said to be evidence of the value of the invention capitalized and therefore of the stock at the time of its issuance. This is upon the principle that a subsequently existing fact is evidence of some probative value of the prior existence of the same fact. (See *Humphreys* v. *Minnesota Clay Co.,* 103 N. W., 338; *Atwood* v. *Bears,* 8 N. W., 55.)

The taxpayer has received something which he did not have before. If what he has received is of value and that value is capable of measurement, he has received income. (19-19-494, supra.) The fact that the stock received sold in the open market within a very short time after the date of its issue and receipt by the taxpayer is strong evidence that it had value at such date and the prices received in such sales are evidence of the measure of its value within the principles above laid down. However—

In the case of subsequent existence as evidence at the time in issue, there is the disturbing contingency that some circumstance operating in the interval may have been the source of the subsequent existence, and the propriety of the inference will depend on the likelihood of such intervening circumstance having occurred and been the true origin. (Sec. 437, Wigmore on Evidence. See also *Doll* v. *Hennessy Merc. Co.,* 81 Pac., 625.)

Consequently, even though the inference is strong that the first prices brought in the sale of the stock in question represent its true market value at the date of issue and receipt by the taxpayer, still the activities of the taxpayer in bringing the stock to the attention of the public in a favorable light might have been the cause for a large portion of the prices so received. Such activities can not, however, be said to account for all of such prices. It is therefore fair and reasonable to conclude, in view of the range of prices over a

period of two years, that the price received over and above the stated par value was due to the taxpayer's efforts at publicity, and that the value of the stock when received by him was its par value. (See *Moffitt* v. *Hereford,* 34 S. W. (Mo.) 252.) . . . .

It is therefore held, in the peculiar circumstances of this case, that stock, based upon a new and untried invention, received in payment for services is income to the person receiving the stock to the extent of its market value. The market value at the time of receipt is to be fixed by taking into consideration the first prices brought for such stock when placed on sale within a reasonable time after such receipt, due allowance being made for intervening circumstances affecting such value. (B. 1-20-656; O. 962.)[33]

The foregoing ruling is quoted in full because it describes the Treasury's method of determining gain. When a loss is claimed the Treasury does not use the same formula. When an inventor endeavors to fix the value of his patents at March 1, 1913, he is not given the benefit of such statements in the ruling as this: "In the case of inventions, their value is dependent upon proven utility or the likelihood of practical usefulness." In no part of the ruling is there any mention of the formula of the Supreme Court in defining income.[34] It must be remembered that only income can be taxed, and only income which has been realized to such an extent that it is the equivalent of cash. The Supreme Court has never approved the principle that income can be imputed to a transaction when the stock or other property received has no market value.

Stock purchase schemes for employees.—

Ruling. Where a corporation offers its employees the opportunity to purchase shares of its stock, and the title to the stock remains in the corporation until it is fully paid for, it is held that the so-called dividends credited to the account of the employee purchasing the stock as part payment for the stock are not in fact dividends, as dividends can not legally be declared on unissued or treasury stock. The amounts so credited, which are measured by the dividends declared on the outstanding stock, constitute additional compensation to the employees and taxable as such.

Where other amounts in the nature of special allowances are, upon the fulfillment of certain conditions, credited to the account of

[33] See Chapters XVI and XVII.

[34] See page 533, *et seq.*

such subscriber as part of the payment for his stock, and where provision is made for the payment of certain amounts in the event the subscriber does not default in any payment on the stock being purchased and complies with certain other conditions, it is held that such amounts are in the nature of additional compensation.

It is held, further, however, that as the interest of the subscriber is merely a contingent interest which may be defeated by failure to execute the terms of the agreement upon which the stock is issued, the so-called dividends and special allowances credited to the account of the subscriber do not constitute taxable income to such subscriber until the terms of the agreement have been completed. (C. B. 4, page 76; O. D. 763.)

In the foregoing ruling, what are called dividends are held to be additional compensation to employees, in which case the payments are allowable deductions to the corporation; whereas dividends are not. In order to carry out the purpose of the corporation, stock equal to the aggregate accruing credits should be issued to trustees who can receive and disburse the dividends in behalf of the beneficial owners.

In the following case the corporation issued the stock to trustees, but the result was a contingent rather than a vested beneficial interest in the employees.

RULINGS. A corporation issued in the name of its employees shares of its stock as compensation for services rendered. The employees executed the certificate of transfer on each share of stock purporting to transfer the stock to the principal owners of the stock of the corporation, designated trustees. The conditions of the purported issuance and transfer of the stock were that it should be held by the trustees until the dividends thereon, paid regularly to the trustees, should equal the par value of the stock, after which the dividends and stock were to become the property of the employees. In case of resignation or discharge of an employee prior to the time of receiving title to the stock, he was to receive the dividends paid to the trustee on account of the stock issued in his name, and in case of his death they were to be paid to his next of kin.

Held, that title to the stock and to the so-called dividends did not vest in the employees until the conditions imposed by the agreement between the corporation and employees were fulfilled. Consequently the payments made to the principal owners of the stock of the corporation, the amount of which was measured by the dividends paid on the outstanding stock, are not dividends as defined by section 201 (a) of the Revenue Act of 1918, but the amount thereof is additional

compensation for services rendered, and constitutes income to the employees in the year in which the title vested in them, subject both to normal tax and surtax.

When title to the stock vests in the employees they should return as taxable income the fair market value of such stock at that time. Any dividends thereafter paid by the corporation would be true dividends as defined by section 201 (a) and subject only to surtax. (C. B. 4, page 76; O. D. 791.)

Where the members of a firm establish an employees' profit-sharing fund by transferring a given sum of money to certain employees in trust, such fund being invested in the business of the firm and the interest paid annually to a certain class of employees, who hold certificates entitling them to participate in the profits of the fund, such certificates being subject to cancellation at the pleasure of the firm, the income from the fund is taxable as a part of the firm's income. (C. B. 2, page 76; S. 1329.)

There are many forms of profit-sharing funds and plans. The Treasury holds that income from such funds, although paid to the employees, is in the first instance income of the owner of the fund and that such owner is the firm when "such fund is neither a separate business venture nor an irrevocable trust." The ruling is sound. The actual payments to employees are an allowable deduction. The restriction on the deduction applies only when the transfer of funds is in name only.[35]

Ruling. Bonuses paid by a corporation, partly in cash and partly in stock of the corporation, which stock was purchased by the corporation on the open market, in accordance with a plan laid down by its board of directors, to the most deserving of its employees (which must be recognized as meaning most deserving on account of services rendered), represent additional compensation to the employees and as such are deductible by the corporation and taxable to the recipients. The fact that the corporation did not deduct the amount representing these bonuses from gross income in its return would not affect the taxability of the bonuses in the hands of the employees. The amount to be considered as taxable income is the actual amount of cash, plus the market value of the stock, when received by the employees. (C. B. 3, page 144; O. D. 570.)

[35] See also section 219 (f).

Compensation received in the form of notes.—

REGULATION. Notes or other evidences of indebtedness received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a 6 or 7 per cent basis, the recipient shall include such note in his gross income to the amount of its face value less discount computed at the prevailing rate for such transactions. If the payments due on a note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted. (Art. 34.)

That is to say, if on October 1, 1921, A received in payment for services rendered a promissory note for $1,000 payable in 6 months, without interest, he would return the discounted value (assuming the current rate to be 6 per cent), approximately $970, as income for 1921. When the note is collected in 1922, he would return $30 as income. The maker of the note, however, is permitted to deduct in 1921 the full $1,000.

If the note bears interest, say at 6 per cent, A would return in 1921 the discounted value, viz., $1,015, and for 1922 he would return $15. The maker of the note would deduct $1,000 in 1921, and $30 in 1922.

If the note could not be discounted no return need be made for 1920. This privilege is extended to instalment houses and it cannot be withheld from others similarly situated.

RULING. A corporation keeping its accounts on the basis of actual receipts and disbursements loans money, the loans being secured by first mortgages on property of the borrowers. The corporation receives as commission second mortgages on the property payable in 5 or 10 annual installments without interest.

The second mortgage notes received as compensation for services should be reported as income at their fair discounted value as at the date of receipt. If the notes are not marketable at a fair discount value, each installment payment should be included in gross income in its entirety by the corporation in the year in which received. (B. 46-20-1302; O. D. 728.)

Although notes may be regarded as "good for face value at maturity," as stated in article 34, if not "marketable at a fair discount," the income need not be reported until payment is made.

In the business of architects, contractors and banks, second mortgage bonds are often taken as part payment for services rendered. These securities usually have no market value. If books are kept on an accrual basis the income to be reported should be on an estimated market or discounted value of the second mortgages. When the books are closed an inventory may be taken since the mortgages are part of the stock-in-trade. If books are kept on a cash basis, the bonds should not be reported as income until realized in cash.

Compensation for services received by partnership.—

Ruling. Shares of stock and cash received by a partnership for underwriting the reorganization of an insolvent concern in which a deceased partner owned stock, the transaction being undertaken in order to protect the interests of the decedent's estate and the entire amount received therefrom being turned over to his estate, represent taxable income to the partnership regardless of the fact that no distribution was made to the individual partners and irrespective of the reasons for which the partnership entered into the transaction. (C. B. 2, page 72; O. D. 542.)

The foregoing is apparently based on the assumption that although the partnership was practically engaged in a charitable undertaking, it received income for services and made a gift to the deceased partner's estate.

Compensation received in the form of rent and board.—

Regulation. . . . . When living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employees, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax. . . . . (Art. 33.)

Many factory superintendents, as part consideration for their services and not necessarily for the convenience of the

employers, are permitted to live, rent free, in houses belonging to their employers. Under this ruling they are required to ascertain the rental value thereof and report it as taxable income. The rental value of a minister's house is exempt from taxation.[36]

While the rules laid down on this point are in themselves equitable, they can scarcely be considered consistent with the rule under which persons owning their own houses are not taxable on the rental value. In other words, there is a discrimination between the man who pays no rent because he lives in the house he owns and the man who pays no rent because he lives in his employer's house, rent free, because of his services. In the latter case income tax is collected on the rental value. In the former case no income tax is assessed on the rental value.

RULINGS. Board and lodging furnished seamen in addition to their cash compensation is held to be supplied for the convenience of the employer and the value thereof is not required to be reported in such employees' income tax returns. (C. B. 1, page 71; O. D. 265.)

Where the employees of a hospital are subject to immediate service on demand at any time during the twenty-four hours of the day and on that account are required to accept quarters and meals at the hospital, the value of such quarters and meals may be considered as being furnished for the convenience of the hospital and does not represent additional compensation to the employees. On the other hand, where the employees are on duty a certain specified number of hours each day and could, if they so desired, obtain meals and lodging elsewhere than in the hospital and yet perform the duties required of them by such hospital, the ratable value of the board and lodging furnished is considered additional compensation. (C. B. 4, page 85; O. D. 915.)

The following rule differs from the foregoing.

RULING. The fair rental value of buildings occupied by employees of the Indian service should be included in the compensation of such employees if the rental value has been charged to the appropriation from which the compensation of the employees is paid and the amount covered into the Treasury as miscellaneous receipts. (C. B. 4, page 85; O. D. 914.)

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[36] Law, section 213 (b-11). See page 422. Prior to 1921, the rental value had to be included in gross income.

Even though the rental is charged to an appropriation it would seem that the quarters furnished are for the convenience of the employees.

RULING. The regulations of the Public Health Service provide that officers of such service are entitled to quarters, heat, and light, and that employees, such as attendants, dietitians, internes, nurses, and reconstruction aids, are entitled to quarters, subsistence, and laundry. These items are furnished to such persons in respect of a service which they render and as an inducement to them to enter the Public Health Service.

It is held, therefore, that the value of the quarters, subsistence, laundry, heat, and light furnished the officers and employees referred to constitutes income to such officers and employees and must be returned by them as income for the year in which received. (C. B. 4, page 112; O. D. 904.)

"SUPPER MONEY" NOT TAXABLE.—

RULING. "Supper money" paid by an employer to an employee, who voluntarily performs extra labor for his employer after regular business hours, such payment not being considered additional compensation and not being charged to the salary account, is considered as being paid for the convenience of the employer and for that reason does not represent taxable income to the employee. (C. B. 2, page 90; O. D. 514.)

Compensation received in the form of heat and light, telephone, automobile and other service.—

REGULATION. Amounts received by, or paid for, an officer for heat and light shall be returned as income. (T. D. 2079, November 24, 1914.)

This applies to army officers who receive, in addition to their salaries and allowances for rent, a further allowance for heat and light.[37] Since the amounts paid are readily ascertain-

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[37] Copy of Office Memorandum No. 17, issued by General Staff, U .S. A., March 3, 1919.

"1. The following letter from the office of the Commissioner of the Bureau of Internal Revenue is published for the information and guidance of all concerned:

'With a view to assisting persons in the military and naval forces of the United States in preparing their income tax returns for the year 1918, attention is called to the holdings of this office under previous income tax acts and to the provisions of the revenue bill as passed by Congress

'It has been held that interest on deposits made with disbursing

able, it may be assumed that all army officers whose aggregate incomes exceed the exemption pay the tax thereon. There are many other individuals who receive allowances of a similar nature and should be taxed thereon. For instance, many corporation officers, particularly those who live near industrial plants, receive or enjoy telephone service, fuel, use of automobiles and many other perquisites which under the ruling cited are taxable. It is usual for officers of automobile concerns, manufacturers and dealers to have the full use of motor cars for pleasure and business purposes. Officers of railroad companies receive passes good over their own and

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officers after September 1, 1917, under authority of section 1305 Rev. Stat., as amended by the act of July 1, 1906, on deposits made under authority of section 203 of the Act of October 6, 1917, and on amounts of compensation not drawn, represents taxable income; and that the following items represent compensation for services rendered and should be returned as income:

'Quarters furnished within the allowance provided by law; or a room furnished as quarters only, that is, a room other than barracks to which several men are assigned.
'Heat and light furnished within the allowance provided by law.
'Allowance drawn from the government as the equivalent of clothing not drawn.
'The commutation of rations.
'Markmanship pay or extra duty pay.
'Traveling pay to discharged officers or enlisted men.
'Mileage allowance, claiming as a deduction the actual necessary traveling expenses.

'Allowance in lieu of subsistence while traveling under orders, claiming as a deduction the actual necessary traveling expenses.

'On the other hand, it has been held that the following items are furnished by the government for its own purposes rather than as compensation to the officer or enlisted man and the money equivalent thereof should not be returned as income:

'Clothing and rations furnished in kind.
'Gratuitous medical and hospital treatment.
'Tent or other temporary shelter.
'Room furnished at a permanent military post used for sleeping quarters and office combined.

'The family allowance provided for under article 2 of the War Risk Insurance Act was held to be subject to tax prior to the amendment of June 25, 1918. In view of this amendment, allotments, family allowances, compensation and death or disability insurance payable under the War Risk Insurance Act of September 12, 1914, as amended, were held to be exempt from tax and the former ruling was made to apply only in the case of assessments made prior to the date of the amendment, June 25, 1918.'"

other lines. These are used for personal as well as business purposes. An individual, for instance, may use a pass to go to and from his golf club or on pleasure trips.

Should emoluments of this kind be reduced to their equivalent in money and be reported as taxable income? The point is really an important one, for the income tax to be successful must be administered impartially and equitably. If army officers, who are not overpaid, are required to pay the tax on the money equivalent of rent, light and heat, then other individuals, most of whom are better able to pay, ought to pay on similar income. "Compensation for personal service of whatever kind and in whatever form paid" is hardly subject to doubt as to its meaning.

One difficulty which will arise is that of drawing the distinction between compensation which takes the form of reduced living expenses (taxable because not allowable as deductions) and the receipt of similar privileges which do not reduce the living expenses of the recipient. For instance, automobiles are frequently furnished to salesmen exclusively for business use. Here, of course, no return would be made. If the salesman is permitted to employ a car for personal or family use, should he ascertain the rental value for the time so used and include such amount as taxable income? The answer is "yes" only in case the salesman would purchase a car himself were this car not furnished free of charge. Only then would the item be the equivalent of a reduction of "personal, living or family expenses." Or, stated another way, return should be made of an amount representing the worth of the automobile service to him personally and individually. If, on the other hand, an officer of an automobile concern has the exclusive use of a car and does use it for other than business purposes, and if it is a fair assumption that he would own and operate a car even if he had to pay for it, then he should ascertain the total cost of operation for a year and prorate such cost equitably, reporting as taxable income the estimated saving of expense arising from the use of the car

as additional compensation. Of course, he would report on the basis of what the actual cost to him would be, taking the benefit of manufacturers' or wholesale prices, rather than what he would have had to pay if he had not been in a position to secure such concessions.

There may be in some cases a question as to whether or not some items like those discussed above are compensation or gifts. This probably depends legally upon the contractual relation between the one who pays and the recipient. If the rent, fuel, automobile and similar privileges are part of the employment contracts, express or implied, and thus show on their face that more or less value attaches thereto, the cash equivalent of the items is taxable. If, however, the privileges are not part of a contract and are pure gifts, and if no diminution of cash compensation results therefrom, they do not constitute taxable income.

Compensation received in the form of per diem allowances and mileage.—The 1918 regulations[38] specifically provided that congressmen, army officers and others who received stated allowances per mile or per diem to cover traveling or living expenses, and allowances for stationery, secretarial services, etc. should return as income any excess of such allowances over actual expenses. Article 101 (a) of the 1921 regulations provides, in effect, for the same procedure. In the case of liberal allowances such as congressmen receive, part of the allowance obviously is taxable and the regulation calls attention to this case specifically. In other cases, such as that of army officers, the allowance closely approximates the expenditure and it may not be worth while to attempt an exact accounting. There is, however, a definite obligation imposed upon the recipient to keep such a record as will indicate at the close of taxable periods whether or not return should be made. The record of deposits in one's cheque book usually is sufficient.

[38] Regulations 45, Art. 292.

The Treasury has held that transportation charges paid by the government on account of the transportation of the families of army officers are in the nature of additional compensation.[39]

RULING. A person in the service of the American Red Cross receiving maintenance but no pay should return as income any excess of the amount received for maintenance over his actual living expenses. (C. B. 1, page 66; O. D. 11.)

Compensation received in the form of deductions for pension funds, etc.—When deductions are made from the salaries or wages of employees (other than public) to cover compulsory or voluntary contributions to pension, sick or insurance funds, such payments or deductions should be added to the amounts received in reporting income which is subject to tax.

REGULATION. . . . . pensions or retiring allowances paid by private persons . . . . are income to the recipients; . . . . (Art. 32.)

Proceeds of accident insurance and damages not taxable.—

LAW. Section 213. **That . . . . "gross income"— . . . . (b) Does not include . . . .**

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness.[40] . . . .

Insurance proceeds, when taxable and not taxable.—

REGULATION. (*a*) Upon the death of an insured the proceeds of his life insurance policies, whether paid to his estate or to any beneficiary (individual, partnership, or corporation), directly or in trust, are excluded from the gross income of the beneficiary. . . . . (*b*) During his life only so much of the amount received by an insured under life, endowment, or annuity contracts as represents a return, without interest, of premiums paid by him therefor is excluded from his gross income. . . . . (*c*) Whether he be alive or dead,

[39] Bulletin 50-21-1975; O. D. 1135.

[40] **[Former Procedure]** Payments made to injured employees by corporations under the accident compensation laws of the several states constitute taxable income of the employees. (T. D. 2570, November 6, 1917.) This was reversed by T. D. 2747 (July 12, 1918), the principles of which are adopted in the present law.

the amounts received by an insured or his estate or other beneficiaries through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are excluded from the gross income of the insured, his estate and other beneficiaries. Any damages recovered by suit or agreement on account of such injuries or sickness are similarly excluded from the gross income of the individual injured or sick, if living, or of his estate or other beneficiaries entitled to receive such damages, if dead. . . . . Since June 25, 1918, no assessment of any federal tax may be made on any allotments, family allowances, compensation, or death or disability insurance payable under the War Risk Insurance Act of September 2, 1917, as amended, even though the benefit accrued before that date. . . . . (Art. 72.)

Article 72 of Regulations 45 is amended as above to exempt the proceeds of insurance paid to a corporation beneficiary, thus complying with the new law.

The above regulation explains the provisions of the statute, which includes in the exemption amounts paid either to the insured or his estate, together with allotments, allowances, and war risk insurance and compensation.[41]

RULING. Where an individual takes out a policy of insurance in favor of his estate which is assigned to a corporation as security for money advanced without interest or other charge to pay a premium thereon, and upon the death of the insured the corporation deducts the amount of the indebtedness from the proceeds of the policy paid to it as assignee, and turns the balance over to the executor of the estate, the corporation should not for income tax purposes include the proceeds of the policy in its gross income. The function of the corporation was merely that of an intermediary in the collection of the proceeds of the policy. (C. B. 4, page 72; O. D. 804.)

PREMIUMS PAID BY CORPORATION—INCOME TO OFFICER IN CERTAIN CASES.—

RULING. If a corporation pays the premiums on an individual life insurance policy carried on the life of one of its officers or employees who is permitted to designate the beneficiary and in which the corporation is not in any way a beneficiary, premiums so paid will, in the absence of satisfactory evidence to the contrary, be presumed to constitute taxable income to such officer or employee. (C. B. 3, page 104; O. D. 627.)

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[41] See page 350 *et seq.*

CHAPTER XV

INCOME FROM BUSINESS

The line between the profits resulting from business, dealt with in this chapter, and the profits resulting from appreciation of property, discussed in Chapter XVII, must be somewhat arbitrarily drawn. Most business, of course, consists of dealing in property, while all dealings in property are usually thought of as "business" transactions.

An attempt is made to distinguish between income from the purchase and sale of merchandise, securities and other property by dealers, and income or profits realized by investors and others who are not dealers. General principles regarding the nature and taxation of appreciation of fixed assets and investment securities, real estate, etc., are discussed in Chapter XVII. Sales and exchanges of property (not forming part of a dealer's stock-in-trade) are discussed in Chapter XVI. The discussion of inventories and other "current" assets is, consequently, retained in this chapter.

LAW. Section 213. . . . . **the term "gross income"—**

(a) Includes gains, profits, and income derived from . . . . trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from . . . . securities, or the transaction of any business carried on for gain or profit, ...

Gross income from business defined.—

REGULATION. In the case of a manufacturing, merchandising or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses or losses, or for items not ordinarily used in computing the cost of goods sold.[1] (Art. 35.)

[1] This statement of course does not modify those sections of the

Business need not be lawful.—The law of 1913 (section II B) provided that the tax was levied on the gains from "any lawful business carried on for gain or profit." In the law of 1916, the word "lawful" is omitted and it does not reappear in either the 1918 or 1921 law. This would seem to indicate a direct intention on the part of Congress to make "stealings" and "winnings" taxable as well as "earnings." Income from gambling and bootlegging would, of course, come under this head.

In this country there is not a large class of professional gamblers or others transacting an unlawful business, but such as can be reached should be taxed. Occasional betting, however, is frequent, millions of dollars being wagered on the results of political campaigns, athletic contests, etc. The winnings are subject to tax. What they win cannot be termed a gift or any other item specifically exempt from taxation, and "gains derived from any source whatever" are taxable. One should, therefore, include all receipts from bets in his income tax return. This in some cases would be a considerable item in the year of a presidential election. It would seem that net losses should be deducted when the transactions were entered into for profit. It would not be wise to claim credit for a net loss arising from betting, but there is a clear obligation to return a net gain.

British practice.—In England it has been held that a professional bookmaker is liable to assessment under the income tax law. The court decided that:

Decision. (Syl.) Persons receiving profits from betting systematically carried on by them throughout the year, are chargeable with income tax on such profits in respect of a "vocation."[2]

In France, also, the government is taxing income from gambling, as stated in a press dispatch. However, in France,

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law and regulations which permit the use of recognized accounting practices. A taxpayer will not be required to change his method of accounting merely to ascertain items of "gross income."

[2] *Partridge v. Mallandaine*, L. R. 18 Q. B. Div. 276 (1886).

gambling is not "illegal" when conducted under government license.

Those who patronize the lotteries on a large scale and whose quarterly winnings may amount to 1,000,000 francs have learned to their dismay that the new taxes strike a double blow at them.

First they must pay 20 per cent outright to the city of Paris as the tax on unforeseen revenues. Then when they have deposited the balance of their winnings in a bank it becomes a part of their general yearly revenue and is taxable another 15 per cent.[3]

SPECULATION IN "FUTURES," ETC.—The purchase and sale of "futures," which chiefly concern those who deal in cotton and other commodities on exchanges, are often called gambling and those who indulge in such transactions do not always consider that their gains are taxable income. It is immaterial whether the transactions are called business dealings, speculation or gambling. If they result in net gain, the profit must be returned as taxable income.[4]

Accounting Procedure

Fiscal year for individuals.—The 1921[5] law provides that an individual may compute his net income on the basis of his "annual accounting period (fiscal year or calendar year, as the case may be)."[6] An individual business man or a partner may simply make his personal tax year coincident with his business fiscal year; or if he desires to make his personal return on the basis of the calendar year, he may report his income from a business to the end of its fiscal year only, without attempting to restate the accounts as of December 31.

It is, however, difficult and annoying to make tax returns for a period other than the accounting period adopted by an individual. The end of December is a very inconvenient time for many taxpayers to state their accounts. Under the pres-

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[3] *New York Herald*, November 21, 1920.
[4] For discussion of deductibility of losses, see Chapter XXIX.
[5] The provision was first inserted in the 1918 law.
[6] Section 212 (b), see page 64.

ent law it is possible to select and report for a year ending on the last day of any month most convenient for the taxpayer.

The receipt or accrual basis and the proper accounting procedure for each are fully discussed in Chapters XIII and XIV.

Computation of business income of contractors.—The business of contracting offers some peculiar difficulties in the calculation of income. The regulations deal with them as follows:

REGULATION. Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term "long term contracts" means building, installation, or construction contracts covering a period in excess of one year. Persons[7] whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon the following bases:

(*a*) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(*b*) Gross income may be reported in the taxable year in which the contract is finally completed[8] and accepted if the taxpayer elects as a consistent practice to so treat such income, provided such method

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[7] **[Former Procedure]** Under the old regulations this special provision for contractors applied only to corporations (Reg. 33, 1918, Art. 121). The term "person," as used in the 1918 and 1921 laws, includes individuals and corporations.

[8] A contractor keeps books on an accrual basis. When the contract is completed the final income must be completed and returned in accord with the regulations whether the work is paid for in full or in part. (B. 52-21-1991; O. D. 1147.)

clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

Where a taxpayer has filed his return in accordance with the method of accounting regularly employed by him in keeping his books and such method clearly reflects the income, he will not be required to change to either of the methods above set forth. If a taxpayer desires to change his method of accounting in accordance with paragraphs (*a*) and (*b*) above, a statement showing the composition of all items appearing upon his balance sheet and used in connection with the method of accounting formerly employed by him, should accompany his return.[9] (Art. 36.)

This regulation is in substance identical with the similarly numbered article in Regulations 45. However, the last paragraph is new and permits a contractor to use his own accounting method, if such method clearly reflects the income, or to change to one of the bases designated by making the necessary adjustments in his accounts.

It has been held that having elected to report on the basis of completed work, amended returns will not be accepted on another basis. A change of basis was allowed, however, as to subsequent years. For Treasury ruling, see C. B. 4, page 80; O. D. 933.

A foreign corporation having a long-term contract from which it had no net income from the United States but receiving gross income therefrom in 1919, was required to file a return showing "its election to report any profit derived from the contract in the year in which it would be completed." (I-3-36; I. T. 1170.)

Contractors should be able to prepare their accounts on the accrual basis. Their difficulties are by no means insurmountable.

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[9] **[Former Procedure]** Regulations 33 and T. D. 2161 (February 19, 1915) did not provide for the adjustment of income of any year which had been overstated or understated, by the filing of amended returns for such period, whereas such provision was contained in Reg. 45, Art. 36.

Reserves for discounts.—In certain industries, notably textiles and leather, it is a general custom to allow high rates of discount for payment in thirty days. These rates may be as high as 4, 6, 7 or 10 per cent. Manifestly customers cannot afford not to avail themselves of discounts at these high rates; in fact a manufacturer would decline to do business very long with any customer who did not make it a practice to pay such bills within thirty days. When the rate of discount is only 1 or 2 per cent, the issue is not of very great importance, but when the rates are higher the amount of tax may be materially affected by whether deduction is claimed for the amount of discount actually taken by customers or for the amount of discount accrued.

The manufacturer recognizes that the face amount of the invoice carrying a high rate of discount should be reduced by the amount of discount in order that his accounts may reflect true income. This is ordinarily accomplished by establishing a reserve both at the beginning and at the end of the fiscal year to offset the amount of discount included in the accounts receivable. A manufacturer who determines his income on the basis of discounts actually taken without allowance for the increase or decrease in the discounts on outstanding accounts receivable is misleading himself.

The amount reserved at the end of a taxable year for discounts which it is expected will be deducted by customers is, in effect, regarded by the Treasury as an allowable deduction.

Ruling. A corporation keeping its accounts on an accrual basis will not be permitted to deduct from gross income a sum in anticipation of the amount the corporation may be required to allow as cash discount on accounts due and payable in the succeeding year. But any amounts so allowed in the succeeding year before the return is filed may be deducted from gross sales for the previous taxable year. (C. B. 1, page 221; O. D. 146.)

The following regulation, providing for the determination of deductions for bad debts, confirms the procedure suggested, and in effect permits the setting aside of the discount which is expected to be allowed on each sale.

Regulation. . . . . If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation. (Art. 151.)

In a ruling on the valuation of goods on hand, the Treasury has held that "taxpayers who as a matter of settled practice do not deduct cash discounts from purchases" may not deduct "the average amount of discount received."[10] It may be inferred, however, that if the taxpayer adopts the practice of deducting cash discounts from purchases, and adheres to it, the deduction will be allowed.

Inventories

When a concern maintains a stock of any kind of property which it periodically renews as it exhausts it, the proper procedure in order to determine profit or loss is to inventory the stock. Regarding inventories the law provides:

Law. Section 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The 1918 law for the first time gave the Commissioner specific authority to *require* inventories, although they have as a matter of fact been used under regulations of the Treasury ever since the passage of the 1909 law.[11]

[10] C. B. 1, page 56; O. D. 326.

[11] **[Former Procedure]** Even under the regulations issued to control the procedure under the 1913 law and in spite of the doubtful authority in the law for the use of the accrual method, the Treasury specified that inventories should be used in certain cases.

Regulation. "In order that certain classes of corporations may arrive at their correct income, it is necessary that an inventory, or its equivalent, of materials, supplies and merchandise on hand for use or sale at the close of each calendar (or fiscal) year shall be made in order to determine the gross income or to determine the expense of operation.

Regulation. In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. . . . . (Art. 1581.)

Estimated inventories are not permitted.—

Ruling. A taxpayer who for many years has elected to take inventory only every two years, and used an estimated inventory in the return for the intermediate year, making any necessary adjustments in the return for the following year when an actual inventory was taken, may not apportion his total earnings for the two years 1917 and 1918 equally between such years for income tax purposes. (C. B. 1, page 62; O. D. 133.)

It would seem, however, that if an estimated inventory which can be verified by the "gross profit" test has been used in former years, and there is no material fluctuation in the rate of gross profit to the date when an actual physical inventory is taken, such estimate must be acceptable.

Inventory must be taken as of one fixed date for entire business.—

Ruling. Taxpayers will not be permitted to adopt one period for inventorying and closing their books applicable to one part of their business and a different period applicable to another part thereof. (C. B. 1, page 62; O. D. 289.)

Inventories in the case of amended returns.—

Ruling. Where amended returns are filed it is not permissible to value the inventories in the amended returns on a basis different from that employed in the original returns, unless the audit of the returns in this office reveals the necessity for employing a different basis. (B. 50-21-1970; O. D. 1132.)

"A physical inventory is at all times preferred, but where a physical inventory is impossible and an equivalent inventory is equally accurate, the latter will be acceptable.

"An equivalent inventory is an inventory of materials, supplies and merchandise on hand taken from the books of the corporation." (Art. 161, Reg. 33, January 5, 1914.)

Regulations 33, 1918, article 120, contained this direction regarding inventories: "and they must be taken where the business consists of buying and selling commercial commodities."

If inventories have been taken on any basis other than that of "cost" or "cost or market, whichever is lower," amended returns may be filed and either one of the two bases mentioned above may be used. In a specific case in which revenue agents at first refused to recognize change from "cost" basis to "cost or market, whichever is lower," they assented when an analysis of the method originally used by the taxpayer showed that the basis was not strictly one of "cost."

What inventory includes.[12]—

REGULATION. . . . . The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. . . . . (Art. 1581.)

The regulation refers to goods "on hand" which is synonymous with a physical inventory. Physical inventories or their equivalent are absolutely necessary in every concern handling materials or goods; but recognized accounting principles do not require that a physical inventory be taken of everything on hand on a specific date. If a book inventory is trustworthy and the entire stock is actually verified in whole or in part at various times during the year, taxpayers need have no hesitancy in stating that article 1581 has been complied with.

The Treasury has ruled that advances to a foreign corporation by an American firm may not be inventoried, even though a considerable decline in the exchange rate has occurred.

RULING. In taking inventory for the purpose of determining taxable net income in accordance with article 1581 of Regulations 45, it is not permissible to include claims which the taxpayer may have against other persons and which have depreciated in value on account of a decline in exchange rates or for any other reason. (C. B. 2, page 50; O. D. 541.)

In view of the tremendous decline in the principal foreign exchanges, any conservative balance sheet would show such

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[12] See page 458, "Goods purchased but not delivered."

assets "inventoried" at the current rate of exchange.[13] Strictly speaking, the word "inventory" does not include accounts receivable, but a fall in exchange rates is equivalent to a fall in the market value of goods. The accrued loss should be claimed. Under the 1921 law it can be included in the reserve for bad debts. Goods of a certain value have been exchanged for other property, viz., a chose in action. When valued at the equivalent of cash the chose in action is worth less than the sales value of the goods. True net income cannot be determined unless the resulting loss is taken into account.

Bailments—when included in inventory.—In some branches of business it is customary to send material to other concerns for certain processing, for instance, bleaching or dyeing. At the date of the inventory such items are included in the inventory if they are to be returned in kind; but some firms have varying arrangements for the return of the "products of the property," such as flour for wheat. In such cases the Treasury holds that this exchange amounts to a sale, and the goods returnable under such arrangements cannot be included in the inventory.

Ruling. The delivery of copper bullion to a smelting and refining company where it is mixed with other bullion and concentrates of different metallic contents under a contract by which the smelting and refining company is to return the equivalent of the metallic contents of such ore previously determined by assay, less commissions and other allowable charges, constitutes a sale and not a bailment. Only so much of the metals as had been redelivered by the refining company at the close of the taxable year belonged to and should have been included in the inventory of the taxpayer as of that date. (C. B. 2, page 45; S. 1373.)

In the detailed opinion of the solicitor the general rule is stated.

But the rule is well settled that when, by the terms of the contract under which property is delivered by an owner to another, the latter is under no obligation *to return the specific property either in its identical form or in some other form in which its identity may be*

[13] See Chapter XIII.

traced, but is authorized to substitute something else in its place, either money or some other equivalent, the transaction is not a bailment, but is a sale or exchange. (*Austin v. Seligman,* 18 Fed., 519, 520.)

The effect of this ruling is to permit concerns to anticipate the profit or loss upon products which have been converted but not delivered to the actual customers. It would apply only to concerns which adopt such practice as a settled policy.

The refined copper returnable to the M Company on December 31, 1917, and December 31, 1918, should, in each instance, have been set up in an account receivable, and if returns were made on an accrual basis, should have been so returned. There is this difference, however, between such an account and an ordinary account receivable, namely, that it is an account receivable in metal and not in money. Under Treasury Decision 2609 and article 1582 of Regulation 45 the copper actually returned to the corporation prior to the dates stated should have been included in the respective inventories as of those dates at cost, or cost or market, whichever was lower, and it would seem clear that the copper receivable could not have had a different value for the purpose of inventory than that which the copper, if actually received, would have had. For the purpose of determining the value of such account, therefore, the copper receivable should be priced at cost, or cost or market, whichever was lower.[14]

The Treasury in the foregoing case has departed from its usual position and has required receivables to be inventoried as if no sale had been made.

General basis for valuation of inventories.[15]—

LAW. Section 202. **(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property,**

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[14] Art. 1582 permits the inventory, under certain conditions, to be taken at less than cost or market. See page 458.

[15] **[Former Procedure]** Cost price was prescribed by the directions printed on the corporation return No. 1031, as revised October, 1916. This is the statement which appeared:

"In case the annual gain or loss is determined by inventory, merchandise must be inventoried at the cost price, as any loss in salable value will ultimately be reflected in the sales during the year when the goods are disposed of."

This direction was ignored by those who desired to have their accounts reflect their actual financial condition. The general Treasury

real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(1) In the case of such property, which should be included in the inventory, the basis shall be the last inventory value thereof; . . . .

Regulation. The Act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the Revenue Act is (*a*) cost or (*b*) cost or market, whichever is lower. . . . .

In respect to normal goods whichever basis (*a*) or (*b*) is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (*a*) cost or (*b*) cost or market, whichever is lower, for their 1920 inven-

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decision dealing with inventories in force at the time of the passage of the 1918 law was as follows:

Regulation. "1. For the purposes of income and excess profits tax return, inventories of merchandise, etc., and securities, will be subject to the following rules:

"A. Inventories of supplies, raw materials, work in process of production and unsold merchandise must be taken either (*a*) at cost, or (*b*) at cost or market price whichever is lower, provided that the method adopted must be adhered to in subsequent years unless another be authorized by the Commissioner of Internal Revenue.

"B. A dealer in securities who in his books of account regularly inventoried unsold securities on hand either (*a*) at cost, or (*b*) at cost or market price whichever is lower, may, for the purposes of income and excess profits taxes, make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that that method must be adhered to in subsequent years unless another be authorized by the Commissioner of Internal Revenue.

"C. Gain or loss resulting from the sale or disposition of assets inventoried as above must be computed at the difference between the inventory value and the price or value at which sold or disposed of.

"2. In all other cases inventories must be taken at cost or at value as of March 1, 1913, ..." (T. D. 2609, December 19, 1917.)

tories, and the basis adopted for that year is controlling and a change can now be made only after permission is secured from the Commissioner. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (*a*) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (*b*) where the taxpayer maintains book inventories in accordance with sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year) the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible maner, properly computed and summarized, and should be preserved as a part of the accounting record of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz.:

(*a*) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(*b*) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(*c*) Omitting portions of the stock on hand.

(*d*) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

(*e*) Including stock in transit, either shipped to or from the taxpayer the title of which is not vested in the taxpayer. (Art. 1582.)

The foregoing regulation is an admirable exposition of good accounting practice and is a vast improvement over some of the former regulations dealing with inventories. It will be found that balance sheets properly prepared reflect good accounting practice in the taxpayers' trade or business. The law gives the Commissioner wide discretion in the matter of inventories and it is to be hoped that many of the irritating

differences of opinion which grew out of former regulations will disappear.

The five methods which are specifically disapproved are in themselves technical departures from good accounting practice. In practice the necessary writing down of inventory values to meet actual market conditions, adhering strictly to the new regulations, will in many cases produce the same net result as if one or more of the methods disapproved had been used.

Early in 1920, the Treasury held:

RULING. . . . . If inventories have been taken in the past on the basis of cost and the request is now made to change to "cost or market, whichever is lower," the reasons for the request should be carefully scrutinized and the request refused if it appears that the principal reason therefor is to reduce the tax payable for 1919. . . . . (C. B. 2, page 54; A. R. M. 38.)

Later, but prior to T. D. 3108,[16] this position was reconsidered on the ground that in "many instances the taxpayer has had no real election, but has been forced to take his inventory on either basis at cost, since cost was lower than market. . . . ."

RULING. . . . . The Committee therefore recommends that Memorandum No. 38 be modified to the extent that where it can be shown that market at the close of 1918 and 1919 was above cost the taxpayer may now elect to take his inventory upon a cost or market basis, whichever is lower, provided that such practice is consistently adhered to in the future, but that the memorandum in question stand so far as it applies to those cases where there was an opportunity to take inventories at a figure lower than cost because market was lower than cost at the close of 1918 or 1919, and consequently there was a real election to continue upon a cost basis. (Ruling 13-20-804. modified.) . . . . (C. B. 3, pages 65, 66; A. R. M. 85.)

"Cost or market price" is not illegal.—The regulations quoted above reiterate and amplify the principles originally laid down in T. D. 2609, the legality of which was questioned; but the Attorney General, to whom the question was referred, "ad-

[16] December, 1920.

vised upon the basis of a decision of the Supreme Court,[17] that the methods of taking inventories authorized by T. D. 2609 are permissible."[18]

Inventories at cost.—

Regulation. Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year (*a*) the cost of raw materials and supplies entering into or consumed in connection with the product, (*b*) expenditures for direct labor, (*c*) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. . . . . (Art. 1583.)

Purchase discounts actually earned are treated by some as a financial gain and by others as a reduction of cost.

Rulings. Taxpayers who as a matter of settled practice do not deduct cash discounts from purchases, but who take the merchandise purchased into their inventories at invoice price (less trade or other discounts other than strictly cash discounts), carrying the discounts in a discount account, may not, in valuing their closing inventories for income tax purposes, deduct from the invoice price of the merchandise on hand at the close of the taxable year the average amount of cash discount received on such merchandise; neither may the amount of cash discount earned, to be reported as income, be decreased by an amount representing the estimated cash discount received on merchandise on hand at the close of the year. (C. B. 1, page 56; O. D. 326.)

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[17] *Doyle v. Mitchell Brothers,* 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054.
[18] 31 Op. Att. Gen. —; T. D. 2744, July 3, 1918. See page 482.

Held, that a wholesale liquor dealer who, for years prior to 1918, exercised the option of including excise taxes in cost of merchandise in calculating inventory may not amend such inventory and treat such taxes as business expenses for 1918. (C. B. 4, page 41; A. R. M. 121.)

Allocated cost method permitted.—

Regulation. A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product which in the aggregate will absorb the total cost of production, may use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds of products. (Art. 1587.)

The foregoing regulation is in accord with the law which permits *any* inventory method which accords with good accounting practice. Special procedure has been prescribed in the cases of the tobacco and lumber industries and may be extended to any other industry in which conditions justify a departure from the general rule.

Average cost method permitted—tobacco industry.—

Ruling. . . . . Tobacco companies taking inventory on the monthly average cost method, no method more nearly approaching theoretical accuracy being practically possible, may continue to use such method in reporting for income tax.

The method followed, as understood by the Committee, is an average cost method and not an average cost or market method. Accordingly, if the market should be below the average cost at the close of a given year, the average cost shall be the basis of valuation and not the lower market price. Companies adopting average-cost methods of inventorying for income-tax purposes should be required to adhere to that method in future years. (C. B. 2, page 50; A. R. R. 18.)

If average cost represents as nearly as can be determined actual cost, and market prices are lower at the end of any year, taxpayers cannot be denied the right to value inventories at market prices.

Average market price not permitted.[19]—

Ruling. A company taking its inventory upon the basis of the average of the market prices prevailing over a period of years does not conform to the method of computing inventories in accordance with articles 1581-1585, Regulations 45, and it should therefore be required to file amended returns. (C. B. 1, page 55; T. B. M. 31.)

Average cost method—lumber manufacturers.—The following illustration shows the importance of the method referred to in article 1587.[20] The point is that each grade is assigned a cost relative to all other grades. If most of the high grade is sold, the low grade remaining in the inventory will not be given an average cost value inflated in effect, by taking in high grade not on hand.

The computation is based on the following:

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[19] For discussion of farm price method, see Chapter XXXIX.

[20] "Lumber Costs," by Edmund M. Meyer, *Journal of Accountancy,"* August, 1921.

Regulation. "1. Because of the impracticability of determining accurately the costs properly assignable to each species, grade, and dimension of lumber making up the product of the mill, lumber manufacturers may use as a basis for pricing inventories the average cost to the manufacturer of producing the inventoried products during the taxable year for which the return of net income is made.

"2. If the quantity of lumber on hand at the time of inventory is greater than the total quantity of lumber produced during the current taxable year, it is evident that the excess stock has been carried over from the previous year's production, and such excess shall be valued at the average cost of production for the preceding taxable year.

"3. A taxpayer who regularly allocates in his books of account such average cost to the different kinds and grades of lumber in proportion to the selling value of such kinds and grades may, subject in each case to the approval of the commissioner upon audit of the return, make his returns of net income on that basis.

"4. The term lumber manufacturer as used in this article means a person who manufactures lumber from logs, as distinguished from a remanufacturer of lumber." (Reg. 45, Art. 1587.)

Species	Feet produced	Per cent of total	Cost of logs sawed	Sawmill expense	Total cost (c) plus (d)
	Production for Year		Cost		
White pine.........	3,806,348	28.27	$ 57,875.16	$21,191.64	$79,066.80
Western pine.......	290,284	2.16	2,243.80	1,619.17	3,862.97
Mixed	9,367,784	69.57	118,975.94	52,150.77	171,126.71
	13,464,416	100	$179,094.90	$74,961.58	$254,056.48

Grade	(a) Feet produced	(b) Market value at end of year per 1,000 feet	(c) Total value	(d) Cost per thousand feet allocated to species and grade 39.02 per cent of (b)
White pine:				
D and better.............	351,170	$132.50	$46,530.03	$51.702
No. 1 common...........	275,600	87.50	24,115.00	34.143
No. 2 common...........	976,864	56.50	55,192.82	22.046
No. 3 common...........	1,331,658	40.75	54,265.06	15.901
No. 4 common...........	658,754	28.00	18,445.11	10.926
No. 5 common...........	212,302	19.00	4,033.74	7.414
Total white pine.........	3,806,348		$202,581.76	......

Ratio of cost of white pine production to its market value at end of year............ $\frac{79,066.80}{202,581.76}$ = 39.02 per cent

Per 1,000 ft.

Average cost = total cost ($254,056.48) ÷ total feet produced (13,464,416) $18.868

Average cost by species: white pine, cost ($79,066.80) ÷ feet produced (3,806,348) $20.772

It would obviously be incorrect to price the low grade ranging from $7.41 to $15.90, at an average price of $18.86 or $20.77, particularly if the inventory contained mostly low grade product.

Inventories at market.—

Regulation.[21] Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases (*a*) of goods purchased and on hand, and (*b*) of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject for cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less proper allowance for selling expense, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market. (Art. 1584.)

The foregoing regulation accords with good accounting practice.

The Treasury now recognizes that the current *bid* price may not represent what a purchaser might have to pay if he attempted to buy in quantities; what the taxpayer would probably pay is a much fairer test of the market value than apparent bid prices in abnormal markets such as obtained at the end of 1921.

The foregoing regulations, in recognizing abnormal conditions, throw a considerable amount of responsibility on the good judgment and good faith of the taxpayer.

Probably the most important factor in fixing market prices

[21] See Chapter XXIX, where claims for shrinkage in inventory losses are discussed.

is quantity.[22] If the quantity on hand is in excess of the reasonable requirements of the taxpayer, the nominal market price for a small quantity usually is not the market price for larger quantities. In a declining market it is proper to assume that replacement market prices for large quantities are considerably below ruling market prices.[23]

At the end of 1920 many users of steel products had placed large orders for steel. When the general price decline came, the demand for their finished product vanished overnight, particularly in the automobile industry, yet the price of forgings and other raw material showed no decline because the steel mills had large accumulated orders on their books. Using the nominal "bid" prices prevailing at the date of the inventory would have compelled these manufacturers to pay taxes at the high rate on enormous inventories which they were not able to liquidate for some very considerable time.

In connection with an interpretation of the terms (a) cost, and (b) cost or market, whichever is lower, questions have arisen as to whether certain items in an inventory may be priced at cost (which is less than market) and other items of exactly the same kind, which cost more, may be reduced to market. For illustration, certain lots of pig iron may have cost $20 per ton. Other lots may have cost $25 and additional lots may have cost $30. When inventory is taken the market price is $25. Where the lots can be readily identified the first lot should be kept at cost, viz., $20 per ton, the second lot should be kept at market, viz., $25 per ton, and the third lot should be marked down to market, viz., $25 per ton.

Article 1582 implies that *in the same inventory* some items may be taken at cost and some (when the market has dropped) at less than cost. No other method would properly interpret the term "cost or market, whichever is lower," nor conform to good accounting practice.

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[22] See R. H. Montgomery, *Auditing, Theory and Practice* (1921 edition), page 127.

[23] See page 468.

RULING. This office acknowledges receipt of your letter of September 7, 1921, making inquiry as to whether Article 1582, Regulations 45, 1920 edition, provides for a change in the method of applying the basis of cost or market whichever is lower, in valuing an inventory.

In reply you are informed that the change of wording in Article 1582, Regulations 45, 1920 edition, is not intended to change the former method of applying the basis of cost or market to each item of the inventory. In employing the basis of cost or market whichever is lower, the lower value of each item listed in the inventory must be placed upon the particular item. You will note that one item may be valued at cost while another may be valued at market. The valuation to be placed on the item is determined by the fact that either cost or market value is the lower. (Letter to Prentice-Hall, Inc., signed by E. H. Batson, Deputy Commissioner, dated September 20, 1921.)

There seems to have been some confusion in the minds of taxpayers as to the practical application of the "cost or market, whichever is lower" method. Ordinarily it is not feasible to segregate or identify the various lots which were sold or still remained in stock. To do so involves a minute segregation of accounts, such as is found in a comprehensive cost system. In the ordinary course the stock purchased first must be assumed to be the stock sold first, and the stock to be inventoried would be that last purchased. The cost of these last lots is compared with the market price, and the lower of the two is taken.

Net selling prices.—A further recognition by the Treasury that apparent market prices are often not real, particularly in the case of goods that are shopworn, obsolete, or that have deteriorated from some other cause, is found in the new regulation. The author has contended in the past that "for many reasons merchandise may have to be valued below cost: overstock; damage or deterioration; changes in styles and shapes; obsolescence—going out of date; sizes and qualities seldom used; broken lots."[24] The new regulations give effect to this contention.

[24] *Income Tax Procedure*, 1921, page 349.

REGULATIONS. . . . . Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less cost of selling whether basis (*a*) or (*b*) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they should be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offerings of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made. . . . . (Art. 1582.)

The foregoing article assumes that the goods inventoried would not be replaced and that they are worth the gross sales price subsequently realized less expense of selling. It is the most reasonable method of inventorying such goods. It does not, however, give to a new fiscal period any element of profit. If the merchandise is of such a nature that the market price can be obtained, it is more conservative to use market prices than net selling prices.[25]

Are the inventory regulations in accord with accounting procedure?—The regulations quoted are in accord with sound commercial practice assuming that "market price" will be construed to mean a fair and reasonable price.

Inventories should be valued at "cost or market, whichever is lower," except when trade conditions or long-continued custom calls for a still lower basis.[26] Apparent market prices may not be true market prices. This is particularly the case in a falling market, but may be equally true when a rising market indicates speculative prices arising out of shortages (which may be only temporary). In such cases, goods pur-

[25] See page 464.
[26] Art. 1584.

chased at the speculative prices may at inventory time appear to be worth cost and the apparent market price may be even higher, but a conservative concern would hesitate before recognizing such values as real. Therefore, no matter how staple or salable the goods may be, if the market price has declined the inventory should be reduced to correspond. As stated in the new regulations, merchandise may for various reasons have to be inventoried below cost.[27]

Portions of inventories usually priced at less than either cost or market.—In some cases it will be necessary to continue to price portions of an inventory at less than either cost or market. Businesses such as those of agricultural implement and automobile manufacturers frequently find that they have on hand large stocks of spare parts which are not worth cost or the nominal market.

As a matter of fact, small quantities may be selling freely and at a very high rate of profit. But inventories must not be taken on the supposition that an entire stock is worth as much proportionately as a small part. A hatter has in stock 100 perfectly good hats. He may sell 50 of them at a good profit. If he then takes stock, and, from experience knows that the most the future market will absorb is 40, ordinary business practice requires him to inventory 40 at cost or market, whichever is the lower, or 50 at the same aggregate price, but at a less unit price. This is not a departure from, but is an adherence to, the principle of inventory valuation which conforms "to the best accounting practice." Future demand is one of the controlling factors in the determination of market prices.

If on December 31, 1921, it were known that the future demand was decreasing, that factor would have its influence on market prices of that date, but no one would be war-

[27] For full discussion of factors which influence inventory valuations, see *Auditing, Theory and Practice* (1921 edition), by R. H. Montgomery, pages 117 to 172.

ranted in assuming that further declines would take place thereafter *unless in previous years it had been customary to carry stock at less than cost or the market.* It is obvious that if such a custom were an old one the government might not lose through its continuance, because a change in policy would result in the adjustment of the returns of previous years, which would in most cases leave the net result for 1921 unchanged.

The Treasury, however, has gone on record as being opposed to the so-called "base stock," "minimum" or "cushion" method. As stated by the Treasury:

> RULING. According to the base-stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. (C. B. 1, page 51; T. B. R. 65.)

In the detailed opinion it was held that:

> The base stock method of taking inventories is not warranted by the law or the Regulations.

The Treasury's arguments against this method are:

1. The method has not been widely adopted.
2. To sanction its use would be discriminatory.
3. It is not the "accounting practice" followed by a majority of manufacturers.
4. It assigns profits and losses on the minimum inventory to the year in which such inventory is liquidated, by ignoring sales of individual items in the inventory and treating the minimum inventory as a unit.
5. It disregards gains that may be considered quasi-capital gains and are taxable under American (as distinguished from British) income tax laws.
6. In substance, it results in offsetting an inventory gain of one year against an inventory loss of another.

Goods purchased but not delivered.—In all cases when goods have been shipped the consignee should consider the

goods as part of his inventory and include the full purchase price among his liabilities. If the market price of the goods at closing time is less than cost the inventory will be reduced.

Regulation. . . . . Only merchandise title to which is vested in the taxpayer should be included in the inventory. Accordingly the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery transfer of title to which has not yet been effected. (Art. 1581.)

The proper taking of "in transit" and other parts of the inventory is facilitated by planning ahead of the inventory date. Careful segregation and compilation of information on the following points will avoid neglect of matters which are often overlooked:

1. Invoices received for goods not yet received.
2. Goods received but no invoices.
3. Goods returned by customers but credit not yet passed.
4. Goods returned and billed back by customers but not yet received.
5. Goods on consignment.
6. Goods at other plants for processing or which are held on order.
7. Goods sold awaiting shipment but not yet billed.

When contracts have been entered into for future delivery, and such contracts are not subject to cancellation, it may be important to consider whether or not any loss has arisen in respect thereto. If the purchases were set aside by the seller and charged on the seller's books to the purchaser, the latter should also reflect the transaction in his books. Otherwise the profit to the seller would have appeared in his tax returns for 1921, but the shrinkage in value, if any, to the

purchaser would not have appeared in the latter's returns until after 1921.

If the goods are not dealt with as sales by the seller, the purchaser can hardly expect to take up any loss on his books.

It may be urged that if a purchaser contracts in November, 1921, for cotton goods to be delivered in January, 1922, and at December 31, 1921, the market price is 10 cents a yard less than the purchase price, he should be able to deduct the 10 cents a yard loss in his 1921 returns as reflecting the market price on December 31, 1921. The answer is that goods not received may never be received; that before the goods are received the market may again advance, and that no loss has been realized.

On the other hand, a true balance sheet of the purchaser would show a reserve for the loss accrued to December 31.[28] If the loss must be set up to reflect actual conditions, there must be some merit in the contention that true net income for the year 1921 cannot be determined unless and until what has taken place in 1921 is reflected in the tax returns.

When there is a considerable shrinkage in prices and it is desired to reflect in the current year the accrued losses on forward orders, it is legal and proper, prior to the closing date, to cancel orders, pay the loss due to cancellation, and reinstate the orders at the current market prices.

In some trades it is customary to place orders for future delivery on the books. In such cases the inventory-at-market

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[28] "The balance sheet, for instance, might show stock on hand large enough or too large for the normal requirements of the business. Unfulfilled contracts outstanding at the date of the balance sheet which call for the receipt of additional stock, which may not be readily salable, will result in an actual liability, whereas the offset, the stock to arrive, will be an asset of doubtful value.

"In every audit, therefore, the auditor should call for copies of all orders for future delivery. If such orders call for stock in excess of the current and reasonable prospective demand, mention thereof should be made in the balance sheet. The details reported should depend on the circumstances of each particular case." [*Auditing, Theory and Practice* (3rd edition), by R. H. Montgomery, page 260.]

basis would enable credit to be taken for the loss in 1921. If such a custom has been followed for a period of years or is general in a trade, it may be continued. Otherwise the practice should not be initiated as at December 31, 1921. Taxpayers are on notice, however, that the Treasury has ruled that goods to which title has not passed cannot be inventoried.

A question arose from a claim for loss under section 204,[29] due to decline in value of the inventory, as to whether or not the material covered by contracts for future delivery could properly be included in the inventory.[30]

RULING. . . . . On September 30, 1918, none of the X material on account of which losses were subsequently sustained had been delivered to the company, and hence none was included in the inventory on which the assessment for 1918 was made. The company did not at that time own this X material, and presumably much of it had not even been produced. The company did not own it but only had a contract for its purchase. It could not, therefore, have properly been included in an inventory of the company's property as of that date. . . . . (C. B. 3, page 88; T. D. 3044.)

Futures.[31]—During the year 1921, the Treasury removed its inhibition against the inclusion in the inventory of such futures as constitute "hedges" against actual spot or cash transactions. Prior to the issue of A. R. M. 135, the Treasury had consistently refused to permit the inclusion of "hedges" in the inventories of dealers in cotton, grain and similar commodities. The author has contended for many years that such disregard for recognized accounting practice is not in accordance with the law.

RULING. The leading cotton and grain exchanges of the country and some of the leading individual dealers in these commodities appeared by counsel or in person before the Internal Revenue Bureau to urge that "hedge" transactions in "futures" shall be accorded recognition in the taxpayer's balance sheet at the close of each taxable year

[29] 1918 law.
[30] See Chapter XXIX.
[31] [Former Procedure] Prior to 1921 the Treasury held that "transactions in 'futures' unclosed at the end of the taxable year form no integral part of the cost of the commodity included in the taxpayer's inventory." (C. B. 3, page 66; A. R. M. 100.)

and shall be thus taken into consideration in computing taxable income. Such consideration has been heretofore denied by the Internal Revenue Bureau to taxpayers engaged in these lines of business for the reason that transactions in "futures" have been held not to be "closed transactions" within the meaning of the regulations, where such transactions, entered into in one taxable year, had been carried forward into the year following.

In thus holding the Bureau appears to have relied very largely upon its previous decision [A. R. M. 100, Dec. 1920 Cum. Bull. p. 66] in which decision there was considered nothing more than inventories of cotton and grain merchants, no other aspects of the case being at that time under consideration, and what was said referred only to the valuation of such inventories and to the proposal to determine profit or loss by treating such transactions either as additions to or deductions from the taxpayers' inventories.

At the hearing the Bureau was deeply impressed with the force of the arguments presented by counsel and with the seriousness of the situation that would unquestionably develop in the cotton and grain trades should the present practice in denying to taxpayers the right of including in their balance sheets their liabilities or assets under these "hedges," be confirmed and established as the recognized practice of the Bureau.

From its previous opinion the Bureau now finds no cause to deviate and holds it to be self-evident without reference to the legal question involved, that any proposition to add to an inventory the value of a commodity, the title to which is not at the time actually vested in the taxpayer or to deduct from an inventory the value of a commodity, the title to which may or may not be vested in the taxpayer, but which is to be delivered only at some time in the future, cannot by any correct system of reasoning or logic be maintained.

The case now presented for consideration involves quite a different principle and the proposition is not identical with, nor in fact in any degree parallel to the previous decision of the Bureau. In the present decision there is involved firm contracts entered into in good faith for a consideration and enforceable under the law, the value of which (and consequently the profit or loss resulting therefrom) can be absolutely fixed and determined at any minute of any business day. To deny to these contracts at any time during their life Governmental recognition as actual liabilities or actual assets (as the case may be) would be futile, nor could such a contention be sustained in the courts where recognition has heretofore been fully accorded them.

The Bureau accordingly holds that dealers in cotton and grain, and in such other commodities as are dealt in in a similar manner, may for the purpose of determining taxable income, incorporate in their balance sheets at the close of any taxable year, such open "future"

contracts to which they are parties as are "hedges" against actual "spot" or cash transactions: *provided*, that no purely speculative transactions in "futures" not off-set by actual "spot" or cash transactions, may be so included or taken into the taxpayer's account in any manner until such transactions are actually closed by liquidation; and *provided further*, that the values of the commodity covered by such open "future" contracts shall not be added to nor deducted from the inventory of the taxpayer. (Special summary of Memorandum No. 135, May 23, 1921, prepared by the Committee on Appeals and Review, for release July 15, 1921.)[32]

It has been held that the ruling made in A. R. M. 135 is applicable to all dealers in commodities "as are dealt in in a manner similar to that outlined in such ruling," and particularly to millers who hedge future contracts for wheat against unfilled flour sales.[33]

Obsolete stock may be written down or off.—The principle of cost or market, when applied to inventory items which have become obsolete or nearly so, is feasible. If there were a reasonable demand for the items they would not be classed as obsolete. If the demand has definitely fallen off or has ceased, the market value has correspondingly declined and such stock may, in accordance with the principle, be written down to its market value or marked off entirely if it has no market value.

In many lines of industry, notably the automobile industry, new designs have rendered obsolete much of the finished goods carried in the inventory. When this is known before the end of the year, the obsolescence is certainly definite and should be reflected in the inventory values.[34]

Income from sales of small quantities which form part of a large lot.—When a stock of materials or goods consists of a number of units it is sometimes difficult to determine the measure of profit or loss which should be assigned to the dis-

[32] For complete ruling, including extracts from briefs filed, see B. 31-21-1750; A. R. M. 135.

[33] [illegible]; I. T. 1166.

[34] For discussion of "marked selling price" valuation applicable to obsolete stock, see page 468.

position of a part of the stock pending the sale of the entire lot. In theory the aggregate of the cost or inventory price can be distributed to each unit and thus the profit or loss on each sale would be easily determined, but in practice it is well known that it may be easy to dispose of part of a large stock whereas the remainder may never be sold.

It is claimed by some that the entire proceeds of first sales should be credited against the entire lot and that no profit should be taken until the purchase or inventory price is exceeded or it is known that it will be exceeded.

In other cases profit or loss is shown in each item as it is sold.

This is one of the questions which must be settled according to good accounting practice. It requires that where unusual conditions obtain, the item should receive special treatment. This, in turn, must be controlled by the good judgment and good faith of those in charge of the business.

The foregoing reasoning is applied to stocks of liquor, since the difficulty of disposing of them has recently increased. The Treasury seems to feel, however, that such stocks have a "market value."

RULING. . . . . The prohibition law, as understood by the committee, permits the use of distilled liquors and wines in the manufacture of medicines and in the filling of prescriptions for medicinal use. The provision for these legitimate demands, therefore, gives to the goods available to supply them some value, and it is presumed that there can be readily established the market value for the supplying of such demands. It is true that the demand is not sufficient to create a market for all the goods held in stock, and that an attempt to sell for this purpose at one time very considerable part of the stocks on hand would doubtless flood the market and break it down to a very low figure. In a measure, however, this was true before the enactment of prohibition laws, as the supply of liquor on hand was always in excess of any immediate demand therefor. . . . . (C. B. 2, page 53; A. R. M. 33.)

Inventories by retail dry goods and other retail dealers.—Among the specific classes of taxpayers to whom special methods of inventorying have been allowed are "retail merchants."

It is noteworthy that the Treasury is recognizing trade practices in various trades and that where they are long established taxpayers are allowed to adhere to them.

REGULATION. Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that basis, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the commissioner. Under this method the goods in the inventory are ordinarily priced at the selling prices, and the total retail value of the goods in each department or of each class of goods is reduced to approximate cost by deducting the percentage which represents the difference between the retail selling value and the purchase price. This percentage is determined by departments of a store or by classes of goods, and should represent as accurately as may be the amounts added to the cost prices of the goods to cover selling and other expenses of doing business and for the margin of profit. In computing the percentage above mentioned, proper adjustment should be made for all mark-ups and mark-downs.

A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods. (Art. 1588.)

While this method in the article quoted is limited to "retail merchants," it will be noted from the following letter of the Commissioner that the method will be permitted to those stores which follow essentially the practices of such retail merchants as retail dry goods stores.

RULING. Reference is made to your letter of January 13, 1921, relative to T. D. 3058, issued August 16, 1920 (Article 1588 of Regulations 45.—Inventories of retail dry goods dealers) asking for further details as to proper procedure within the meaning of the regulations. Your questions are taken up and answered in the order in which you presented them.

1. The use of the retail method is by the decision confined to retail dry goods dealers. Other organizations and individual stores who conduct retail establishments and follow essentially the retail method of dry goods stores, may be allowed this method upon application to the Bureau of Internal Revenue.

2. *The designation of the method as a "cost" method.* It was not

intended that the apparent limitation should be inflexible. It is recognized that on a constant or rising market the retail method is approximately a "cost" basis, and that on a falling market it results in a reduction to "cost or market whichever is lower."

3. *Preserving records.* There must be a permanent form of recording by departments, purchases showing the firm name, date of invoice, invoice cost and retail sales, stock, etc. It must be borne in mind that under no circumstances will arbitrary standard percentages of purchase mark-up be allowed in the determination of the "cost" or "cost or market" value of retail inventories; but that such percentages must be the purchase mark-up percentage disclosed by the department records of the fiscal period for which the return is made.

4. *Opening inventory.* In Section "A" the words "the value of all merchandise as received" is inclusive of inventory at the beginning of the period. The purchase mark-up must be computed as follows:

Cost: Inventory at cost at beginning: purchases at cost; transportation.

Retail: Inventory at sales price: purchases at sales price.

5. *Appreciation in retail values of goods on hand.* Within the meaning of the Article, it is proper to include as a part of "original retail sales price" the actual increase in the original sales price which has been brought about by market conditions or by incorrect pricing when the goods were put into stock. For the convenience of the examining officer, a special form should be provided; complete information by items of the increase from the original retail must be shown; reference, if possible, must be made to the original invoice; entry and the reason for the increase freely explained. All such amended retail increases must be approved by the buyer of the department and merchandise manager or other responsible official and they should be so filed that quick reference to them may be made. Entry of such increased retail prices properly belongs in department purchase books, although it may be set up as a separate item in the accumulated records of the department. The same forms that are used to record such price increases should not be used for mark-downs and in no instances will a store be allowed to include as retail increases a mark-up which has been taken as a correction or cancellation of a mark-down; such mark-up must be regarded and treated in all cases as opposite to mark-down.

6. *Proper mark-downs substantiated by record of facts will be permitted.* The decision is not intended to disturb the procedure in stores which have properly handled mark-downs, but instances where arbitrary reductions from retail values have been made because of the desire to provide for depreciation and obsolescence with no actual offering to the public of the goods on which the mark-downs were claimed, cannot be recognized. Under no circumstances will a store be

allowed to depreciate its stock in any way except by the offering of it to its customers at such reduced prices. The procedure of stores in regard to mark-downs will be deemed proper if in any fiscal year or period of that year the goods so marked down are in proportion to current sales, stock on hand, to mark-downs of preceding months of preceding year, or if evidence can be submitted as to market changes which have forced a reduction in retail prices necessary to bring about a parity with the selling price of the same goods which have been purchased or could be purchased at a reduced cost.

In conclusion it should be noted that a store which has employed this retail method in the past, may now specify in the return that such method is used, as a basis of valuing inventories, regardless of the fact that in past years it reported on a "cost" or "cost or market, whichever is lower" basis. However, the use of the retail method will not be recognized unless it has been correctly followed throughout the entire fiscal or calendar year period for which the return is made. (Letter to the National Retail Dry Goods Association, New York, N. Y., signed by Commissioner Wm. M. Williams, and dated January 21, 1921.)

Market value of goods in process and finished goods.—One of the most difficult problems of manufacturers arises from work in process and finished goods.

This question is of major importance in a time of demoralized markets, such as have confronted so many industries at the close of 1920 and 1921.

The following comparison illustrates the problem:

FINISHED GOODS

	Actual Cost	Replacement Cost, i. e., Actual Market
Material	$100	$ 50
Labor	200	120
Overhead	200	200
Totals	$500	$370

This assumes that material has declined 50 per cent and labor 40 per cent. Overhead may remain at the same figure or be changed.

Work in process should be valued by applying the ratios of decline thus obtained to the *actual* cost of the inventory of goods in process. Different stages of completion will require adjustment.

The Treasury permits the foregoing adjustment of material prices and also permits the replacement basis in labor and expense items. The physical property which is inventoried is goods in process (or finished goods). If goods and wages have declined, the product of goods and wages declines in value. An inventory is not at "market" unless it is adjusted to what is practically a replacement basis as at the date of the inventory.

In addition to the present cost of replacement, consideration should be given to the selling prices in effect for such goods, goods in process and finished goods at the present time, which for inventory purposes should be valued at not more than their selling value less shipping or other costs yet to be incurred.

The selling price of goods is a measure of the demand for them and a supplemental indication of their present market value, even when market value is considered from a replacement rather than from a sales point of view.

Goods sold for future delivery.—Article 1584[35] provides that goods sold for delivery at fixed prices already agreed upon and on hand at date of inventory, must be inventoried at cost. If sold at prices which yield a normal profit, the requirement is sound if there is no possibility of cancellation and if the credit of the buyer is beyond question.

When goods for future delivery have been sold at a loss, they should be inventoried at market, as if they were not sold.

The following authoritative statement has been made public by the American Institute of Accountants.[36]

> The treatment of inventories by companies having contracts for sale of goods at prices yielding a profit above cost was considered. It was agreed that where goods have been bought specifically for such contracts, they should be taken at cost even if that be higher than market, both for general accounting and tax purposes. This should apply only if the contracts are enforceable contracts with responsible

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[35] See page 464.

[36] Special Bulletin No. 7, December, 1920.

people—not in cases where enforcement would involve such risk of a bad debt as to be unwise. It was recognized that the question as to applying goods on hand to such contracts where they were not earmarked was difficult, and the firm (of accountants) should not be disposed to question any reasonable course adopted by any client in this matter.

RULING. . . . . In the contracts involving the delivery of goods in the future the company at no time makes any particular appropriation of any particular goods to fill any particular order or portion thereof until the time specified for the delivery of the goods to the carrier. At the time of entering into the contract, in a majority of the cases the purchaser gives his promissory note in settlement for the goods. The notes do not bear interest until maturity, and generally the due date of the note is fixed at the time of the delivery of the bulk of the order if that time is determinable at the time of entering into the contract. The nature of the goods is such that they deteriorate rapidly, consequently only such goods are manufactured at any particular time as are necessary to fill and complete shipments of orders for delivery at the particular time the goods are manufactured.

Held, that under the provisions of section 213 (a) of the Revenue Act of 1918, the M Company is not required to treat its contracts covering unfilled and undelivered orders for its goods as gross sales for the year in which the order is taken and the contract entered into, but that the sale of the goods can not be properly considered as having taken place until the goods are delivered to the carrier for shipment to the buyer, or in those cases in which the purchaser is to call for the goods at the place of business of the company, until there is a specific identification of the goods manufactured and they are put in a deliverable state. (C. B. 4, page 95; O. D. 826.)

Where no specific goods are appropriated to the contract, but deliveries are made from regular stock, such goods should be inventoried on the basis of cost, or cost or market, whichever is lower, depending on which of these two methods is employed by the taxpayer.

Notice to Treasury of method adopted.—When the peculiar conditions of any business make a literal compliance with the regulations difficult or impossible, it is advisable to attach a statement to the return to the effect that inventories were taken at what the taxpayer believed to be market values, but that owing to the difficulty of ascertaining trustworthy mar-

ket values the taxpayer reserves the right to amend the return if it subsequently be found that the information was inaccurate.

Dealers in securities may use inventory method.[37]—

REGULATION. A dealer in securities who in his books of account regularly inventories unsold securities on hand either (*a*) at cost or (*b*) at cost or market, whichever is lower, or (*c*) at market value, may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the commissioner. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers, with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person,[38] the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, and not in the course of an established business, and officers of corporations and members of partnerships, who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule. A dealer in securities is not entitled to the benefits of section 206[39] with reference to the gain from the sale of securities. (Art. 1585.)

Many "dealers in securities" are partnerships. Securities which are really investments may have been carried in the inventory. If it is desired to secure the benefits of section 206 (capital gains), there seems to be no reason why such securities should not be taken out of the inventory and carried as investments, if they are such in fact.

Prior to issuance of T. D. 2609 (December 19, 1917), those

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[37] [Former Procedure] Dealers in securities were included in the provision entitling taxpayers to adopt "cost or market, which is lower" as a basis for 1920 inventories. (C. B. 4, page 52; M. 2703.)

[38] Banks and other institutions having established departments for the merchandising of securities.

[39] Section 206 refers to capital gains. See Chapter XVII.

who dealt in things other than "materials, supplies and merchandise" were not permitted by the regulations to calculate their losses or gains by the usual methods, but were required to keep an accurate record of each item (even if these items ran up into the tens of thousands), its cost and the date and its sale and the date (even though many years subsequent). Most taxpayers were unable to comply with these requirements and therefore their modification became necessary. The Treasury announced that the authority for T. D. 2609 and for the general extension of the inventory method to dealers in securities was an opinion of the Attorney General,[40] viz.:

RULING. The Attorney-General has advised upon the basis of a recent decision of the Supreme Court [*Doyle v. Mitchell Brothers*, decided May 20 last (247 U. S. 179)] that the methods of taking inventories authorized by T. D. 2609 are permissible. That decision, supplemented by the last paragraph of T. D. 2649 defining "a dealer in securities," therefore continues to stand as a regulation of the Department. (T. D. 2744, July 3, 1918.)

T. D. 2649 (January 30, 1918) agrees substantially with article 1585 as regards the definition of a "dealer in securities."

Since the case of *Doyle v. Mitchell*,[41] relied upon by the Attorney General, arose under the 1909 law, and since all Supreme Court interpretations of a revenue law are retroactive to the date of the law, it follows that dealers in securities have had full power to inventory their securities under all income tax laws since 1909.

The privilege, extended to taxpayers by article 1582 (as amended in December, 1920, by T. D. 3108), of changing from the "cost" basis of valuation to "cost or market," is applicable to dealers in securities.[42]

Who may or may not use inventories is clearly indicated, in so far as the Treasury is concerned, by reference to T. D. 2609, referred to above. "An individual, partnership, or corporation, with an established place of business and whose prin-

[40] 31 Op. Att. Gen.
[41] 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054.
[42] C. B. 4, page 52; Mim. 2703.

cipal business is the purchase of securities, and their resale to customers," implies a general definition. For "securities" substitute merchandise, stock-in-trade generally, or any other commodity forming the essential productive factors in the principal business of the taxpayer, and those commodities are subject to the process of inventorying. The test is legitimate dealing and manufacturing as against spasmodic or "on-the-side" dealing.

There is not much difference between a "dealer" who buys and sells securities and a "speculator" or an investor who buys and sells securities. In many cases taxpayers who claimed that they were "dealers" and who were denied the classification by the Treasury, will now benefit by the capital gains privilege.

INVENTORY METHOD—WHEN APPLICABLE TO "SHORT SALES."—

RULING. Where a taxpayer has "borrowed" stock in order to make a "short sale" the gain or loss arising from such transaction can not be accrued upon the books of the taxpayer at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold "short" as of that date; the gain or loss is determined when the amount of stock sold "short" is repurchased for return to the lender and the transaction closed. (C. B. 1, page 62; S. 1179.)

The Treasury holds that "the short sale dealer in open short sales, having no stock in his possession to which he has title, consequently has no stock which he can inventory."

When applied to one who is not a dealer in securities the ruling is sound, but there is no good reason why a dealer in securities should not inventory all his trades, at least to the same extent as is permitted in the case of "hedges." (See page 472.) The case is not analogous to dealing in futures or to the forward business of dealers in merchandise. Short sales are not usually made as "hedges" but in the ordinary course of business as individual transactions. The dealer does have physical property to inventory, viz., the cash proceeds of the sale. But the cash proceeds are worth more or less than

their face value, depending on fluctuations in the price of the stock or other property which must be replaced in kind. Therefore the cash reserve must be increased or decreased at inventory time or the accounts will not reflect the results of the dealer's business on an accrual basis.

The author is of the opinion that a dealer in securities should be permitted to inventory short sales on the basis of cost or market, whichever is lower.

The inventory method is supposed to make unnecessary the closing of trades to establish closed transactions. What can be done indirectly should be permitted if done directly. A dealer can readily cover all his short sales before the end of the year and arrange to resell the same or similar classes of stocks, etc., immediately thereafter, but he should not be required to go through a foolish form when the inventory regulations provide a more reasonable method.

RETURNS OF DEALERS IN SECURITIES.— In preparing returns on form 1040, the taxpayer who has qualified as a dealer in securities is not required to enter the items of his business in schedule D,[u] but should use schedule B. On line 1 of schedule B there should be entered the sales price of all securities sold, and on line 4 there should be entered the cost price of securities purchased. When the dealer has kept his books on an accrual basis and has taken inventories, lines 6 and 8 should be used to record the inventories at the beginning and end of the year. If it is not feasible for a dealer in securities to enter the gross sales price in line 1, because his books show only gross profits, he should then enter the item of gross profits on line 1 and not attempt to set up the cost of securities held on line 4. This method is permissible because it accords with accepted accounting principles.

But schedule B is not intended to be used by those who are not dealers in securities. Speculators or investors who may carry on many hundreds of transactions during the year must

[u] All references in this chapter are to 1921 forms.

either qualify as dealers in securities or they must report under schedule D. It has been urged that an active trader cannot readily prepare schedules which show the sales price and cost of all securities dealt in. If such trader keeps books show- the details of each transaction and if he keeps an account showing the gross profit or gross loss on each transaction, it may be permissible to use such totals in schedule D with an explanation that those figures agree exactly with the regular books of accounts kept by the taxpayer and open to the income tax inspectors. On the other hand, if such taxpayer does not keep regular sets of books which can readily be verified, the Treasury is fully justified in requiring the detail of every transaction during the taxable year. If some such compilation is not made, the taxpayer himself does not know what his profits or losses have been and, if a compilation is made, there is no reason why a copy of it should not be attached to form 1040 in support of schedule D totals.

INVENTORIES OF SECURITIES BY A BANK MAINTAINING A DEPARTMENT FOR DEALING THEREIN.—

RULING. Reference is made to your letter of May 26, 1919, wherein you ask whether a bank that maintains a branch for the purpose of buying and selling securities has the full status of a recognized dealer in securities.

In reply, you are advised that a bank or other institution having a regularly established department for the merchandising of securities, even though that department is subordinate in importance to other departments, is entitled to the same benefit of using the basis provided for in Article 1585 of inventorying securities acquired and held for resale, as one who is solely a dealer in securities.

In so far as the bank or other institution carry on, with an established place of business a department for the merchandising of securities, it is in respect of such department treated in the same way as any other security merchant. It should be noted, however, that the method of inventorying provided for in Article 1585 has no application and can not be extended to taxpayers simply buying and selling securities for investment or speculation. (Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, dated June 28, 1919.)

Dealers in foreign exchange may use inventory method.—

RULING. A dealer in foreign exchange—that is, one who regularly engages in the purchase and resale to customers of foreign money with a view to the gains and profits that may be derived therefrom—who, in his books of account regularly inventories unconverted foreign money on hand either (a) at cost or (b) at cost or market value whichever is lower, may make his return upon the basis upon which his accounts are kept.

A taxpayer who is not a dealer in foreign exchange but merely purchases foreign money on his own account or as an incident of his principal business may not inventory such unconverted foreign money at the close of his taxable year. The realization of the gain or loss is postponed until the foreign money is disposed of or converted. (C. B. 4, page 61; O. D. 834.)

When foreign exchange is purchased incident to the business such as that of an importer, there would seem to be no good reason why the amount held at the end of the year should not be inventoried. It is as to such importer an asset used in trade, and should therefore be subject to the usual rules for valuing trade assets.

Dealers in second-hand automobiles may use inventory method.—

RULING. A dealer may value used or second-hand automobiles included in a closing inventory on the basis of cost or market whichever is lower, in accordance with article 1582 of Regulations 45, if he can furnish satisfactory evidence of the market value of such second-hand automobiles at the date of the inventory. (C. B. 4, page 49; O. D. 888.)

Real estate dealers not permitted to use inventories.—

RULING. A taxpayer, engaged in the real estate business, is not permitted to inventory real estate which is held for sale for the purpose of calculating net income subject to Federal income tax. (C. B. 4, page 47; O. D. 848.)

Method of valuing inventories when a partnership is succeeded by a corporation.—The question arises as to how an opening inventory should be taken when a corporation succeeds a partnership, the latter having taken its closing inven-

tory at cost, and the market value now being greater than cost.

If the transfer constitutes a closed transaction (and the partners have paid a tax on the appreciation), the opening inventory of the corporation for tax purposes would be the increased value. If the transfer is a continuing transaction, the basis used by the partnership should be continued.

Under the 1921 law,[44] however, such a transfer would not be a closed transaction if the control of the corporation is in the former partners and "the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer." It would appear that, on the one hand, the partners need not pay a tax on such appreciation at the time of the transfer, and that, on the other hand, the corporation may take up the inventory at its present value as the corporation is a separate entity and therefore may properly value any property acquired by it at the value it had at time of acquisition and for which its securities are issued.

At first glance it might appear that some income is escaping taxation but this is more apparent than real. The corporation as such pays no tax on the appreciation, as it occurred prior to its acquisition of the property. The members of the former partnership, however, would pay on the appreciation if, as, and when realized by the sale of their holdings of the corporation's stock. Under the 1921 law[45] their investment in the corporation's stock is in such a case deemed to be the same as their investment in the partnership which had valued the inventory at cost.

Income from Sale of Property on the Instalment Plan

Under T. D. 3082, October 20, 1920, amending article 42 of Regulations 45, the Treasury made it possible for instal-

[44] Section 202 (c-3).
[45] Section 202 (d).

ment dealers, under the 1918 law, to report only profits realized in cash collections.

The same procedure is permitted under the 1921 law.

LAW. Section. 202. . . . . (f) **Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.**

Generally speaking, the regulations consider sales to be on the instalment basis when less than 25 per cent of the purchase consideration passes to the vendor at the time the sale is effected, and when the balance of the consideration is payable in specific instalments. Such a condition obtains whether the title rests with the vendor until purchase is completed, whether the title passes to the vendee under a lien agreement, whether the title be reconveyed to vendor by a chattel mortgage, or whether title be conveyed to trustees pending performance of contract.

REGULATION. Dealers in personal property ordinarily sell either for cash, or on the personal credit of the buyer, or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25 per cent) that the sale, though involving deferred payments, is not one on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (a) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (b) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (c) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for

bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from installments sales, (such collections being allocated to the year against the sales of which they apply), which the annual gross profit to be realized on the total installment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale or contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the installment plan of computing net income, no part of any installment payment received subsequent to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the installment payment is received; the intent and purpose of this provision is that where the entire profit from installment sales has been included in gross income for the year in which the sale was made, no part of the installment payments received subsequently on account of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance sheet should be adjusted conformably. If for any reason the vendee defaults in any of his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible. (Art. 42.)

When can sales of personal property be deemed to be on the instalment plan?—

Rulings. If a stockholder of a corporation sells stock to employees of the company for consideration of 10 per cent cash and the balance in installment payments, secured by notes covering a period of 10 years, that proportion of each installment payment received during the taxable year which the gross profit to be realized bears to the gross contract price should be reported as income for the year during which installment payments were received. (C. B. 1, page 75; O. D. 134.)

Where the stockholders of a corporation sell their shares in the corporation for a price in excess of cost and receive a cash payment not in excess of 20 per cent of the total price, the purchasers agreeing to pay the balance in a number of semiannual installments and deposit collateral with trustees as security for the faithful performance of

the contract, the transaction is not an installment sale within the meaning of article 42, Regulations 45. The entire consideration involved in the sale must be treated as the equivalent of cash in the year when the sale is consummated. (C. B. 1, page 75; O. D. 290.)

The last ruling may or may not be sound, depending on the circumstances of the case. If the deferred payments (80 per cent) are not *in fact* the equivalent of cash, no tax can be imposed. Under the law no income arises until the *actual* equivalent of cash is realized. Many deferred payments are not discountable on any reasonable basis. In such cases the following ruling governs.

RULING. In the case of sales of personal property where substantial initial payments are made (more than 25 per cent of sale price), obligations of the purchasers need not be regarded as the equivalent of cash if it is shown clearly that such obligations, even though represented by notes or other paper in negotiable form, can not be discounted or otherwise converted into cash without material loss because of lack of credit on the part of the buyer and the nature of the property involved. In such cases profit may be reported as provided for sales on the installment plan. (C. B. 3, page 107; O. D. 715.)

The foregoing is sound and in strict accord with the law.

The author has been unable to ascertain why instalment houses should receive consideration not extended to any other class of taxpayers and wholly unjustified by any reasonable interpretation of the regulations regarding closed transactions.

Other businesses in changing from one method of accounting to another have always been required to file amended returns as far back as may be necessary to protect the government's interests. Other businesses in which accounts and notes receivable have been less liquid than the notes receivable taken by instalment houses have been required to return the entire profit on the accrual basis. The instalment house sells goods for a substantial cash payment and often takes promissory notes for the balance. The latter are more readily discountable in ninety cases out of one hundred than are the securities re-

ceived in exchanges of other property; but under the regulations no tax is imposed until the notes are collected at maturity.

The treatment of instalment houses is not too liberal; the injustice lies in the refusal of the Treasury to interpret the 1918 and prior laws with half as much liberality in thousands of cases in which taxpayers were far less able to pay the tax.

Method of computing taxable profit by instalment houses. —The detailed procedure outlined in the following ruling serves to give effect to two principal changes in the Treasury's former requirements.[46]

First. Any collections applicable to instalment sales already reported as income are credited to accounts receivable. No part of such items is used in computing realized profits for the taxable year. This avoids double taxation.

Second. Collections as made are segregated according to the years in which the sales were made. Segregation is also made in the books for each year of—

(a) Sales
(b) Gross profit (unrealized)

Ratio of (b) for each year to (a) for each year for which cash is collected in current year applied to the collections in current year gives income to be reported as realized profits of current year.

To illustrate, assume:

	Collections made during 1921	Instalment sales contracts (Sales made during respective years)	Goods sold in respective years (cost value)	Unrealized profits on instalment sales contracts	Per cent gross profit
Applicable to 1920.....	$2,000	$30,000	$24,000	$6,000	20%
Applicable to 1921.....	8,000	50,000	37,500	12,500	25%
	$10,000	$80,000 (a)	$61,500	$18,500 (b)	

The problem is to compute the realized profits. The rul-

[46] See *Income Tax Procedure*, 1920, pages 309-314.

ing says that such profits should be computed by taking the same percentage of the cash collections made during the taxable year on account of instalment sales contracts of either that or prior years, as the total unrealized profits on instalment sales contracts for the year against which the collection applies, bear to the total instalment sales made during that respective year.

Applying the gross profit for each year to the collections applicable to the respective years, we have:

1920, 20 per cent of $2,000 = ...	$ 400
1921, 25 per cent of $8,000 = ...	2,000
Realized profits for 1921	$2,400

RULINGS. The procedure outlined in T. B. R. 24[1] has been reconsidered and as a result of such reconsideration the following has been adopted where a taxpayer engaged in merchandising upon the installment plan has heretofore made returns upon the basis of treating the profit upon installment sales as realized as at the date of sale and now wishes to change to the basis of reporting the profit as being realized as at the date of collection of the outstanding accounts.

1. In accordance with the provisions of article 42 (as amended) of Regulations 45, the balance sheet as at the beginning of the taxable year, which shall be filed as a part of the return, shall carry the installment sales contracts unliquidated and remaining in force as at the date that this system of accounting is adopted and made effective by the taxpayer, as accounts receivable, such unliquidated installment sales contracts having been inventoried and determined as at that date. Cash collections on account of such contracts will be credited directly to such accounts receivable and no part of such collections will be included in computing realized profits for the taxable year.

2. As from the beginning of the taxable year, the following accounts should be set up:

(a) *Goods purchased*, which will be charged with the amount of inventory of the goods on hand at the beginning of the taxable year and with the expenditures for goods purchased during the year.

(b) *Goods sold* (cost value), which will be credited with the cost value of all goods sold during the year.

(c) *Installment sales contracts* (year date), which will be charged only with the amount of installment sales contracts made

[1] Under the former ruling, when a change was made in the instalment method, cash collections applying to sales already reported were included in the new computation.

during the year specified. This account for each year will be credited with all cash collected during that year, or in subsequent years, upon installment sales contracts *for that year only*, and with the unpaid installments of defaulted or canceled contracts for that year.

(d) *Unrealized gross profits on installment sales contracts* (year date), which will be credited only with the amount of unrealized gross profits upon installment sales contracts made during the year specified. This amount will be the total of the installment sales contracts for that year reduced by the cost or inventory value (as carried in account (a) goods purchased), of the actual goods sold and covered by the contracts; the balance remaining being the amount of the unrealized gross profits. The proforma monthly (or annual) journal entry would be:

	Dr.	Cr.
Installment sales contracts (year date)......	$......	
To goods sold (cost value)......................		$......
Unrealized gross profits on installment sales contracts (year date)		$......

(e) *Realized profits on installment sales contracts,* which will be credited from month to month (or at the end of the year), with the profits realized by cash collections upon all installment sales contracts of any year. Such profits should be computed by taking the same percentage of the cash collections made during the taxable year on account of installment sales contracts of either that or prior years, as the total unrealized profits on installment sales contracts for the year against which the collection applies, bear to the total installment sales made during that respective year. Corresponding debits should be made to *unrealized gross profits on installment sales contracts* for the year affected by such collections. If adjustments to any or all of these various accounts become necessary in order that it or they may accurately reflect the facts, such adjustments may be made either monthly or as at the end of the taxable year.

It is believed that sufficient has been said above to indicate the use that is to be made of these special accounts and it is not necessary to discuss any of the other accounts which would normally be maintained.

It will be noted that the foregoing plan which will be permitted upon an explicit statement of facts made to the Commissioner of Internal Revenue by a taxpayer engaged in merchandising upon the installment plan is not a change from an accrual basis to a cash received and paid basis. In the opinion of this office, the income of a merchandising concern can not be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is, therefore, merely such a modification or adaptation of the ordinary accrual method of accounting as in the opinion of this office will enable the accounts of the taxpayer clearly to reflect

his net income. Where in the past another method has been used that has failed to reflect the taxpayer's net income an amended return or returns for such year may be made.

In cases where the taxpayer has in the past exercised the option of reporting the profit as realized as at the date of sale and now wishes to change to a basis of reporting the profit as realized as at the date of collection of the outstanding installments, either of which method is allowable under article 42 of Regulations 45, amended returns for years prior to the date that the above outlined system of accounting is adopted and made effective by the taxpayer, will not be required or allowed unless in the opinion of the Commissioner such former method has failed to reflect the net income. (C. B. 3, page 105; O. D. 623.)

O. D. 623 does not contemplate that where a change is made to the basis of reporting the profit from installment sales as being realized as at the date of the collection of the outstanding accounts, any part of the unliquidated installment sales contracts at the date the new basis is adopted, which are to be carried as accounts receivable on the balance sheet at the beginning of the taxable year in which the change is made, should be excluded from surplus in computing invested capital for the taxable year. (C. B. 4, page 87; O. D. 793.)

If books have been so kept that the cost of each article sold was not shown, gross profit may be determined by taking the average percentage of gross profit on gross sales. If several different lines of merchandise are handled, on which the average percentages of profit differ, the gross profit on total sales of each different class of merchandise should be computed separately. (C. B. 1, page 75; O. D. 25.)

Where a taxpayer is engaged in business making cash, personal credit, and installment sales, the percentage of gross profit to be reported on the installment sales, as provided in article 42 of Regulations 45, is the percentage of gross profit on all sales made during the year in which the installment sale was made, regardless of whether they were cash, personal credit, or installment sales. (B. 47-21-1930; O. D. 1107.)

The two preceding rulings are confusing. In O. D. 25 taxpayers are required to make separate computations where the percentage of gross profit on different classes of goods sold on the instalment plan differs materially, whereas in O. D. 1107 taxpayers are required to compute gross profit on all classes of sales.

In the case of instalment houses which have adequate cost records, the latter ruling does not give accurate results and is

contrary to the principle laid down in article 42 of Regulation 62, that the income "may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from instalment sales . . . . which the annual gross profit to be realized on the total instalment sales made during each year bears to the gross contract price of all such sales made during that respective year." As a practical matter it may apply to a concern which can not segregate the cost of items sold on the instalment basis from other sales.

Application of instalment payments.—Since collections made in one year may apply to sales made in different years, each showing a different rate of gross profit, the following rules for applying the cash payments made by customers are important in determining the proportion of such payments to be reported as income.

RULINGS. When income from sales of personal property on the installment plan is reported as provided in article 42 of Regulations 45, the payments made by a purchaser having several accounts should be allocated to the particular account or accounts to which under the terms of the contracts of sale such payments are to be applied. (B. 39-21-1838; O. D. 1045.)

In cases of continuous accounts covering sales of personal property, the income from which is reported on the installment plan as provided in Treasury Decision 3082, the cash payments received should be allocated in accordance with the generally recognized principle of law governing such cases, that is, that failing application by the vendee, the cash payments should be applied to the earliest items of the account. (C. B. 4, page 88; O. D. 815.)

Computation of bad debts in case of instalment sales.—

RULING. The amount to be deducted from gross income as a bad debt in cases of sales of personal property on the installment plan in which the unpaid installment obligations of the purchaser become worthless and are charged off and the property is not recovered by the vendor is such proportion of the defaulted payments as represents the capital investment, that is, the cost of the goods sold, and this amount must be deducted for the year in which the default occurred.

Let it be assumed that the taxpayer's installment sales (contracts) for the year 1919 were $300,000 and that the cost of the goods sold

and covered by such contracts was $100,000; then the unrealized gross profits would be $200,000 and the rate of profit for that year would be established at 66⅔ per cent.

Let it be assumed, further, that during the years 1919 and 1920 the cash collections on account of such contracts were $266,700; then the entries covering these transactions would be as follows:

Installments sales contracts, 1919	$300,000	
To goods sold (cost value)		$100,000
To unrealized gross profits on installment sales contracts, 1919		200,000
Rate of gross profit—⅔ or 66⅔ per cent.		
Unrealized gross profits on installment sales contracts, 1919	177,800	
To realized profits on installment sales contracts		177,800
Cash collections during 1919 and 1920 for account of 1919 ... $266,700		
⅔ thereof ... 177,800		

At the close of 1920 the accounts, as affected by the above transactions, would stand as below:

DEBITS		CREDITS	
Cash	$266,700	Goods sold (cost value)	$100,000
Installment sales contracts, 1919	33,300	Unrealized gross profits, etc.	22,200
		Realized profits, etc.	177,800
	$300,000		$300,000

Of the above balance of $33,300 to the debit of installment sales contracts, two-thirds, or $22,200 (shown as a balance to the credit of unrealized gross profits), is to be accounted for and taxed as profit as, when, and if collected. The remaining one-third is the capital investment representing the cost of goods sold.

But let it be assumed that the whole or any part of the balance of the installment sales contracts, amounting to $33,300, was defaulted in 1919 or at any later time; then the question arises: How should the loss occasioned by such defaults be treated for purposes of determining the income and excess profits tax?

The answer is that the proper portion (two-thirds in this case) of the amount of the defaulted payments should be charged against the unrealized profits and the balance (in this case one-third), representing the cost of the goods sold, should be allowed to the taxpayer as a deduction for losses actually sustained during the taxable year.

This method of treatment should be followed whether the goods are or are not recovered. If the goods are not recovered, it correctly reflects the facts without further entries upon the books. If the goods are recovered, their fair market value at the time of recovery should be credited as realized profits for that year, with a corresponding debit

to the account of goods purchased. The difference (debit balance) between the two accounts of goods purchased and goods sold should reflect the value of the physical inventory at any given date. (C. B. 4, page 86; O. D. 792.)

Reserves for unearned interest, collection expenses, etc., good accounting practice.—

RULING. A taxpayer who sells merchandise on the installment plan may not allocate the expenses incident to producing the income to the year in which the profits on the sale of the goods are realized, but should deduct such expenses in his income-tax return as for the year in which incurred and paid or accrued. (C. B. 4, page 123; O. D. 844.)

When goods are sold on the instalment plan there is included in the sales price an adequate allowance for bad debts, for the costs of collection, interest and other carrying charges. No specific segregation of the selling price is made, but the items are there nevertheless. There can be no net income until provision is made for costs and expenses. Usually collection and similar expenses are relatively small, but in the instalment business such expenses are high. At the end of each accounting period (or oftener), if accounts are kept on the accrual basis, there should be taken out of gross sales on the instalment plan such part thereof as may be said to represent the actual cost of carrying and collecting the accounts. If the future costs and charges can be segregated with reasonable accuracy into interest, collection charges, and similar expenses, the separation should be made.

It is somewhat doubtful whether reserves of this kind were allowable deductions heretofore, but since the 1918 and 1921 laws call for the use of the best accounting practice in each trade, there should be no question about the propriety of setting up such reserve accounts to provide for interest and expenses charged to customers, but not collected from the customers and not yet expended for these purposes. When returns are made on the cash basis now permitted, these reserves cannot be claimed as deductions.

Income from the sale of real estate on the instalment plan.—

Regulation. Deferred payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows:

(1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount. They include (*a*) sales where there is immediate transfer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (*b*) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid.

(2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the instalment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments.

In determining how these classes shall be treated in levying the income tax, the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year, or on the entire consideration made up in part of agreements to pay in the future. (Art. 44.)

When obligations of purchasers are not the equivalent of cash.—

Regulation. In the two kinds of transactions included in class (1) in the foregoing article, installment obligations assumed by the buyer are not ordinarily to be regarded as having a readily realizable market value,[48] and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be

[48] **[Former Procedure]** Permission to calculate a proportion only of instalments received as realized income was conditioned upon "title remaining in the vendor until fully paid for." (Reg. 33, 1918, Art. 117.)

In the regulations covering the 1918 law the expression "equivalent of cash" was used instead of "readily realizable market value." (Reg. 45, 1918, Art. 45.)

income to the vendor and will be so returned for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself (less any depreciation as defined in articles 161 and 162). If the taxpayer chooses as a matter of settled practice consistently followed to treat the obligations of the purchaser as having a readily realizable market value and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in article 46 will apply.[49] (Art. 45.)

RULING. In February, 1917, A purchased land and improvements for a consideration of $46x$ dollars. On September —, 1917, an agreement for the sale of the property was entered into between A and his wife, parties of the first part, and B, party of the second part, for a consideration of $70x$ dollars, payable as follows:

$\frac{1}{4}x$	dollars	cash,	receipt of which is acknowledged,					
$9\frac{3}{4}x$	dollars	cash,	to be	paid	on	or before	November —, 1917,
$3\frac{3}{4}x$	"	"	"	"	"	"	December —, 1919,
$3\frac{3}{4}x$	"	"	"	"	"	"	December —, 1920,
$3\frac{3}{4}x$	"	"	"	"	"	"	December —, 1921,
$3\frac{3}{4}x$	"	"	"	"	"	"	December —, 1922,
$3x$	"	"	"	"	"	"	December —, 1923,

and the balance thereof, to wit: The sum of $42x$ dollars to be paid on or before the —— day of June, 1927, in accordance with the *note* and mortgage executed by the parties of the first part to C, which mortgage is of record, all deferred payments to draw interest at y per cent per annum, interest payable annually, and the party of the second part reserves the right to pay said sums at the due date thereof or any part thereof in multiples of $100 at any time, and upon receipt of the payment of any such sum, interest on such sums so paid shall thereupon cease.

In determining the amount of the initial payment it has been the practice to consider as the equivalent of cash mortgages assumed by the purchaser. In the present case, however, it does not appear that the purchaser assumes the mortgage on the property referred to above. He merely agreed to pay an amount to the seller equal to the amount of the mortgage on or before June —, 1927, as the final payment on the property. That the seller was not released by this agreement from liability on the mortgage is indicated in the statement in the letter from the taxpayer's representative that "the holder of the original mortgage against the property refused to release the taxpayer until payment of his obligation has been made in full." The amount of the mortgage, $42x$ dollars, should not, therefore, be considered as the equivalent of cash in determining the amount of the initial payment in this transaction. (B. 46-21-1918; A. R. M. 140.)

[49] See page 500.

Even if the mortgage had been assumed in the foregoing case, the sale would still be one of an instalment nature, since the down payment was small.

Where lien notes are given to cover future payments for property purchases, such notes are considered as cash to the extent of their discountable value.[50] When land is sold for part cash and part oil, if oil is found, the right to receive oil has not a "definitely ascertainable value" and no income is realized until the total payments received by the vendor exceed the cost or March 1, 1913, value of his land.[51]

When obligations of purchasers are the equivalent of cash.—

Regulation. In class (2) in article 44 the obligations assumed by the buyer are much better secured because of the margin afforded by the substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. If these obligations have a readily realizable market value, as defined by article 1564, they are to be considered as the equivalent of cash and the profit realized from the transaction is taxable income for the year in which the initial payment was made and the obligation assumed. If the buyer defaults and the seller regains title to land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss in the year of repossession any excess of the amount previously reported as income over the amount actually received, and must include such real estate in his inventory at its original cost to himself (less any depreciation as defined in arts. 161 and 162.) If the obligations have no readily realizable market value, the amount of the initial payment shall be applied against and reduce the basis, as provided in section 202 and articles 1561-1564, of the property sold and if in excess of such basis, shall be taxable to the extent of the excess. (See art. 1658.) Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the basis as provided above and the amount realized therefor. (See arts. 153, 1561, and 1568.) (Art. 46.)

Even though the first payment is substantial in amount, if it is made in some form (note, property, etc.) that has not

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[50] C. B. 4, page 89; O. D. 842.
[51] C. B. 4, page 89; O. D. 889.

a readily realizable market value, the transaction is not closed and no income is realized.[52]

The two foregoing articles (45 and 46) must be reasonably construed. If transactions in class (2) are substantially the same as those in class (1) the Treasury could not hold that one is the equivalent of cash and the other not.

INITIAL PAYMENT INCLUDES ALL PAYMENTS DURING TAXABLE YEAR.—

RULING. An individual who sold a parcel of real estate in 1918 for $60x$ dollars received a payment of $5x$ dollars on March 1, 1918, the date on which the sale was consummated, a payment of $2\frac{1}{2}x$ dollars on July 1, 1918, and a payment of $10x$ dollars on December 1, 1918, or a total of $17\frac{1}{2}x$ dollars during the year 1918. It was provided that the balance of the selling price would be paid in installments falling due on December 1 of each year thereafter, including the year 1922, such deferred payments being secured by crop mortgages and additional collateral security.

In order to ascertain whether this sale comes within the ruling in article 45 of Regulations 45 under which a taxpayer is permitted to report only the proportionate part of each installment payment representing profit as income for the year in which received, the entire amount of the selling price received in cash during the taxable year in which the sale was made is to be taken into consideration in determining whether or not the initial payment was a substantial one. Since in this case the sum of the payments received in 1918 was more than one-fourth of the selling price, the vendor should have included the entire profit realized on the sale in his return for 1918. (C. B. 3, page 108; O. D. 569.)

It is, however, reasonable to assume that the security for the deferred payments was not the equivalent of cash, in which case the entire profit should not have been held to be taxable in 1918.

PAYMENT IN NOTES NOT READILY DISCOUNTABLE.—

RULING. In the case of real estate sales involving deferred payments, even though substantial first payment is made, if the notes given by buyers of real estate can not be discounted nor sold on account of lack of credit of the buyers, such notes need not be re-

[52] For full discussion, see Chapter XVI.

garded as the equivalent of cash, and the vendors may report as their income from the proposed transaction for each year only the proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. (C. B. 1, page 76; O. D. 181.)

If because of decline in value and curtailment of credit, notes given for property cannot be marketed, the sale of the property may be treated as one made for deferred payments.

RULING. . . . . inasmuch as the notes covering the unpaid balance of the purchase price are not merchantable because of lack of credit on the part of the purchasers and the decrease in the value of farm land since the date of the original sale agreement, it is held that the transactions in question should be treated for income tax purposes as deferred payment sales of real estate on the installment plan. The administrators of the estate of . . . . should, therefore, include in the income tax return of the decedent for the period from the beginning of his taxable year to the date of his death, that proportion of each installment payment received by the decedent during such period which the gross profit to be realized when the property is paid for bears to the gross contract price. (Extract from letter to John E. Hughes, Chicago, Ill., signed by Acting Deputy Commissioner E. H. Batson, by M. E. Stickley, Head of Division, dated April 27, 1921.)

PAYMENT IN USED CARS.—

RULING. A dealer in automobiles who takes used machines as part payment on sales of new cars is required to report the entire profits realized on the new cars for the year in which received regardless of the fact that part of the payments received are in the form of used machines. The fair market value of the used cars taken as part payment is deemed to be the value at which they were taken in on the sales.

In case the used cars are later sold, the basis for determining gain or loss will be the value placed on them for income tax purposes when received, or if inventories are employed and the cars were on hand at the beginning of the taxable year in which sold, the value at which they were included in the inventory at that date. (C. B. 4, page 31; O. D. 782.)

Under the 1921 law the term "readily marketable" would be substituted for the words "fair market value." It is probable that in the automobile trade the former term is more acceptable.

Sale of real estate in lots.—

Regulation. Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such the cost shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income, may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss on every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for as provided in article 1561.[53] (Art. 43.)

The new regulation refers to any gain "which constitutes taxable income." For discussion of those transactions in which no gain is deemed to be realized, see Chapter XVI.

Ruling. . . . . For income tax purposes the sale of a perpetual easement on a specified number of acres of land to a railroad company is to be treated as though it were an outright sale of land where legal title passes at the time of sale, unless for some reason the fee of the owner has more than a merely nominal value, as for example, where the land is underlaid by a mine. (B. 43-21-1881; O. D. 1072.)

Estimated development work may be included in cost.—

Ruling. Profit realized on the sale of lots, the selling price of which includes the cost of certain development work already made or to be made in accordance with the contract of sale, should be based on the cost of the land to the vendor, or its fair market value as of March 1, 1913, if acquired prior to that date, plus the actual and estimated future expenditures for development. If the estimated future expenditures should be subsequently ascertained to be incorrect, amended returns should be filed as the basis for an adjustment of the tax for the years affected. The cost of such development having been taken into consideration in determining profit, expenditures for this purpose can not be deducted from gross income in subsequent returns. (C. B. 3, page 108; O. D. 567.)

Repossession of real estate sold on instalment plan.—The foregoing regulation states that in case of repos-

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[53] See Chapter XVI.

session "the property repossessed must be included in the inventory at its original cost."

Under another ruling, real estate dealers are not permitted to inventory real estate.[54] Article 46,[55] which refers to real estate sales not on the instalment plan, uses similar language, as does article 42, which deals with sales of personal property on the instalment plan. Since the Treasury has held that real estate dealers may not use the inventory method, this gives them the benefits of the capital gains provisions.[56] The foregoing ruling merely provides that the cost of real estate sold and returned must not be written down. The net proceeds arising from the sale and return are of course taxable.

Proceeds of Property Requisitioned or Destroyed[57]

Special provision has been made to prevent excessive taxation in cases where compensation is received for property lost or destroyed through fire, storm, shipwreck or where property is taken under right of eminent domain, or requisitioned by the government for war purposes,[58] which is temporarily not replaceable. In such cases "replacement funds" may be established and the tax accounting postponed "for a reasonable period of time."

LAW. Section 214. (a) . . . . **(12) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat**

[54] See page 486.
[55] See page 500.
[56] Section 206.
[57] [Former Procedure] T. D. 2706 (April 25, 1918) provided relief only in cases of property lost through war hazards. It also provided for the deduction of any mortgage obligation on such property from the replacement fund. Further, it permitted the valuation of the replaced property at an amount greater than that at which the old property was carried "to the extent that such new or restored property has an increased productive capacity."

Some of the provisions now incorporated in the 1921 law were heretofore included in Reg. 45, Arts. 49 and 50, but without specific provision of law. See *Income Tax Procedure*, 1921, pages 374-377.

[58] C. B. 4, page 43; O. D. 897.

or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts. . . . .

LAW. Section 202. . . . . (d) . . . . (2) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted; . . . .

The 1921 law permitting the establishment of a "replacement fund" has several new features.

1. The acquisition of 80 per cent or more of the stock of a company owning property similar to that lost is deemed a replacement. Under the old regulations it was necessary to "replace the property" lost or destroyed.

2. Under the 1921 law an amount of the gain resulting from recovery may be deducted based on the proportion of such proceeds expended for replacement to total proceeds.

Assume the following:

Cost of asset destroyed		$200,000
Less: Depreciation to date of conversion		50,000
Depreciated cost		$150,000
Amount recovered		250,000
Profit deferred		$100,000
Amount expended in replacing assets substantially in kind	$150,000	

Amount of profit allowed as deduction from income:

$$\frac{150{,}000}{250{,}000} \text{ of } 100{,}000 = \ldots\ldots \quad 60{,}000$$

Taxable profit .... $ 40,000

The old regulation dealing with the profits to be reported reads: "the excess of the amount received over the amount actually and reasonably expended to replace or restore the property."[59]

The foregoing regulation was drafted at a time when replacement costs were greatly in excess of normal, and undoubtedly it was not expected that replacement would be made at an amount less than original cost or March 1, 1913, value. However, if property was replaced in 1920 at less than cost, the gain would be measured by the excess of the amount recovered over cost or March 1, 1913, value. In other words, the higher basis would be used in computing the profit.

3. The property acquired takes the place of a like proportion of the property converted. In the illustration above, the property acquired would be assigned a "cost" of $\frac{150{,}000}{250{,}000} \times \$150{,}000$, or $90,000, for the purpose of computing gain or loss on subsequent sale,[60] and for depreciation.

4. The provisions of the 1921 law are made retroactive to all prior income and profits tax laws as regards exemption from tax.

Accounting for proceeds of conversion.—

Regulations. In the case of property which has been compulsorily or involuntarily converted into cash or its equivalent as a result of (a) its destruction in whole or in part, (b) theft or seizure, or (c) an exercise of the power of requisition or condemnation or the threat or imminence thereof, that amount received by the owner as compensation for the property which is in excess of the cost of the property (or other basis) should be included in gross income. However, the gain to be included in gross income in the case where the property was acquired before March 1, 1913, and its fair

[59] Reg. 45, Art. 49.
[60] Section 202 (d).

market value as of that date was greater than its cost, is the excess over such value of the amount received. No taxable gain results when the amount received is more than the cost but less than the fair market value of the property as of March 1, 1913. In any case proper provision shall be made for depreciation to the date of the loss, damage, or transfer. However, if the taxpayer proceeds forthwith in good faith to replace the property, as provided in Section 214 (a) (12), see Articles 261-263. . . . . (Art. 49.)

Sections 214 (a) (12) and 234 (a) (14) of the statute deal with cases where property is compulsorily or involuntarily converted into cash or its equivalent as a result of fire, shipwreck, theft, condemnation or similar causes enumerated in the statute. Under regulations prescribed by the Commissioner with the approval of the Secretary, the taxpayer is permitted to deduct gains which may be thus involuntarily realized (through insurance or otherwise) when he proceeds forthwith in good faith to expend the proceeds of such conversion (1) in the acquisition of other property of a character similar or related in service or use to the property so converted, (2) in the acquisition of 80 per cent or more of the stock or shares of a corporation owning such other property, or (3) in the establishment of a replacement fund. When only part of the proceeds of such conversion is thus expended (for example, one-third) a corresponding part of the gain (in the example given, one-third) may be deducted. The statute also provides that for the purpose of determining gain or loss the property acquired takes the place of a like proportion of the property converted (in the example given, one-third). (See Sec. 202 (d) (2) and art. 1567.)[61] The or restored property, to the extent of the replacement, shall not be valued in the accounts of the taxpayer at an amount in excess of the cost of the old property (or of its value as of March 1, 1913, if acquired before that date and such value is higher than the cost) after making proper provision in either case for depreciation of the original property, plus the cost of any actual additions and betterments.

This provision relating to the involuntary conversion of property applies, so far as may be practicable, to the exemption or exclusion of the proceeds thereof or the gains derived therefrom from gross income under prior income, war profits, and excess profits tax acts. Articles 261, 262, and 263 have no application to property which is voluntarily sold or disposed of. As to replacement funds, see article 263. (Art. 261.)

The law gives the taxpayer three lines of procedure.

1. To replace the property with property similar in character or related in service.

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[61] See Chapter XVII.

2. To acquire a minimum interest of 80 per cent in the stock of a corporation owning such property.
3. To establish a replacement fund.

If a shipping company suffers the loss of one of its ships and, to obtain the use of another, purchases 80 per cent or more of the stock of another company owning a ship which can be used to replace its loss, such purchase of stock is deemed a replacement.

Should the taxpayer not elect to follow any of the three courses of procedure outlined in article 261, any gain accruing from the transaction is taxable.

REGULATION. In cases of involuntary conversion of property within the provisions of sections 214 (a) (12) or 234 (a) (14) the gain must be included in income and no deduction will be allowed unless the taxpayer proceeds forthwith in good faith to expend the proceeds of such conversion in any of the three ways described in article 261. If the taxpayer does not elect so to expend the proceeds of the conversion, the gain, if any, shall be ascertained as provided in article 49. (Art. 262.)

Replacement substantially in kind.—

RULING. Where a taxpayer elects to replace a vessel by one somewhat larger, so long as the general type of the boat is the same as the boat lost or destroyed, it may fairly be taken as a replacement in kind within the meaning of article 49 of Regulations 45, in so far as it equals the tonnage of the original vessel. There should be charged against the replacement fund only such portion of the cost of the new vessel as would represent the cost of a boat of the carrying capacity of the old vessel, with allowance for depreciation. The period during which the replacement fund may be maintained may properly be limited to one year with the privilege of the taxpayer to apply at the end thereof for a further extension of time. (C. B. 1, page 76; T. B. M. 61.)

When, however, the replacement is another type of vessel, such as a barge in place of a tug, the Treasury denies the relief.

RULING. Where the owner of a requisitioned tug uses the proceeds to buy barges, this is not a replacement in kind as to come within the provisions of articles 49 and 50 of Regulations 45. (C. B. 1, page 77; O. 914.)

Corporation purchasing replacement property from subsidiary.—

RULING. Where one of an affiliated group of corporations which file a consolidated return established a replacement fund in accordance with the provisions of article 50, Regulations 45, the expenditure of the replacement fund so established to replace a steamship in kind is not a replacement within the meaning of that term, when the steamship acquired to replace the one lost was acquired from another of the affiliated corporations. (B. 48-21-1942; A. R. M. 142.)

Replacement funds.—

REGULATION. In any case where the taxpayer elects to replace or restore the converted property, but where it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage, and pending the disposition thereof the deduction shall be tentatively allowed. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund and in his application should recite all the facts relating to the transaction and undertake that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require for an amount not less than the estimated additional income and war-profits and excess-profits taxes assessable by the United States upon the income so carried to the replacement fund. (See Sec. 1329 of the statute.) The estimated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy. (Art. 263.)

The principal change in the foregoing article is that "part or all of the compensation" may be held in the replacement fund, instead of the "entire amount."

The replacement fund may consist of compensation in cash and proceeds of property returned to taxpayer, when such property has been materially damaged.

RULINGS. Where the Government having requisitioned vessels from a taxpayer for use in the war, returns the same vessels in an unfit condition for their former use, giving the taxpayer a sum of money in lieu of restoration, the vessels are deemed to be substantially different property from that taken from the taxpayer, and the taxpayer may elect to sell the vessels returned and place the proceeds, together with the money paid him in lieu of restoration, in a replacement fund established under Articles 49 and 50, Regulations 45. (C. B. 1, page 78; T. B. R. 41.)

Where business property was destroyed by fire and the taxpayer immediately replaced such property with property of substantially the same kind, the excess of the cost of replacement over the amount of insurance received as compensation for the property destroyed can not be taken as a loss. It is treated as a capital expenditure, which is recoverable through depreciation deductions. (C. B. 3, page 110; O. D. 697.)

The principle of the foregoing rulings may be best illustrated by the following examples:

RULING. 1. When recovery "is less than damage sustained:"

Cost of asset	$5,000.00
Replacement cost	$5,000.00
Recovery	$4,000.00
Loss	$1,000.00

2. When recovery is "less than an amount necessary to make good the damage:"

Cost of asset	$5,000.00
Replacement cost	$11,000.00
Recovery	$10,000.00
Loss (?)	$1,000.00

The investment, at cost, as indicated in each of the above illustrations is $5,000. This is the capital sum that may be returnable through depreciation or claimed as a loss if the asset is damaged or destroyed. In the recovery for loss or damage there is necessarily a conversion. In this conversion there would ordinarily be an immediate profit or loss determined by the amount of recovery. But under Treasury Decision 2706 the determination of the profit or loss is deferred.

This decision provides that an amount so recovered (by requisition of property for war purposes or because lost or destroyed in whole or in part through war hazard) may be set aside in a "replacement fund" and "pending the disposition thereof the accounting for gain or loss thereupon may be deferred for a reasonable period of time." The *excess of the amount so recovered* "over the value or cost of the property, *except so far as actually used* for the replacement of the

property in kind, is subject to the income, war income, and excess profits taxes." This decision, therefore, provides for the determination of gain by use of the replacement fund. If the entire fund is expended to replace in kind there is no profit or loss because an asset of no greater or lesser value has been acquired. Substantially there is no conversion—merely a substitution.

The substitution of the asset "in kind" is only one transaction and the profit or loss is measured by the use of all or a part of the replacement fund—not by an amount in excess of the replacement fund. Thus, if the recovery (as in illustration No. 1) was $4,000 on an asset valued at $5,000 and it cost $5,000 to replace the asset, the deductible loss is $1,000. But if the recovery (as in illustration No. 2) was $10,000 the immediate profit of $5,000 can not be converted into a loss of $1,000 if it cost $11,000 to replace the asset. Any expenditure in addition to the amount recovered and held in the replacement fund represents the conversion of a current asset (cash) into a fixed asset.

The Committee accordingly concludes that an amount in excess of recovery for loss expended for replacement of an asset "in kind" is not deductible as a loss when the entire fund so recovered is equal to or greater than the book value of the asset. (C. B. 4, page 92; extract from A. R. M. 122.)

The foregoing ruling would work out as follows: A concern owned a ship which was carried on its books at cost (or value March 1, 1913), less normal depreciation, viz., $100,000. In 1919 it was lost or destroyed. Insurance amounting to $300,000 (its insurable value) was collected. Under the regular practice income and excess profits taxes would be collected on $200,000.[62] On the assumption that it would cost $300,000 to replace the old ship with a new one no better than the old, the 1921 law (retroactive in this respect to taxes under previous income and profits tax laws) permits the taxpayer to credit the entire amount received to a replacement fund, and to withhold the payment of any tax on the excess received, provided[63] bond is filed for the tax which would be due if immediately assessed. If a new ship, which is "substantially" the same as the old, is purchased out of the replacement fund, at a cost of $300,000, no tax will be payable if the new ship

[62] If the ship is not replaced income tax would be assessed on $200,000, but relief might be granted as to the excess profits tax in certain circumstances. See Appendix A, Chapter XV.

[63] Art. 263.

is carried in the accounts of the taxpayer at an amount not greater than that at which the old ship was carried.

If the replacement is made at a cost of less than $300,000, say for $150,000, the gain to be reported is that proportion of the proceeds in excess of cost which the amount expended for replacement bears to the amount recovered, viz.,

$$\frac{150{,}000}{300{,}000} \text{ (or } \tfrac{1}{2}\text{) of \$200,000, or \$100,000.}$$[64]

Under the 1921 law [section 202 (d-2)] a new prorated "cost" ($50,000) would be assigned to the replaced property, viz., that proportion of the cost of the property converted ($100,000) that the amount expended for replacement ($150,000) bears to the amount recovered ($300,000), that is, one-half. If the replacement cost is $350,000, the excess of cost over compensation received, viz., $50,000, must be added to the book cost, and must not be taken as a loss.

The provision that the new ship must not be valued on the books at more than the book value of the old one is equitable, because if it were so valued there would be an amount credited to profit and loss account upon which no tax had been assessed.

Cash received from Alien Property Custodian.—The amount of cash received from the Alien Property Custodian as a return of property seized[65] by him may be placed in a replacement fund. The provision is broad enough to include property seized by him under the law and converted into money.

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[64] [Former Procedure] T. D. 2706, approved April 25, 1918, read in part: "This excess of the amount received *over the value or cost of* the property, except so far as actually used for the replacement of the property in kind, is subject to . . . . taxes."

Art. 49, Reg. 45, (promulgated January 28, 1921) reads, in part, as follows: "the gain, if any, is measured by the excess of the amount received over the amount actually and reasonably expended to replace or restore the property." But see text on page 506.

[65] Section 214 (a-12) reads "as a result of . . . . seizure."

Recoveries for Damages, Patent Infringement, Claims, Bad Debts, etc.

Regulation. Gains, profits and income are to be included in the gross income for the taxable year in which they are received[66] by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. . . . . A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. . . . . (Art. 51.)

The foregoing article is a fair interpretation of the legal definition of income even though in many cases it has resulted inequitably. When accounts are kept on an accrual basis and an obvious error has been made, the returns of prior years may be reopened and corrected. When income is not reported for taxation because it is not deemed at the time to be taxable income, no just criticism can be imputed to a regulation which holds that if income was not reported when it appeared to accrue it must be reported when it is realized.

When items which have never been included in gross income or which have been charged off as bad are collected, they are *prima facie* taxable income of the year of realization. The courts carry this theory to an extreme not warranted by business practice. Good accounting practice requires that there be taken up as *accrued* and taxable transactions, those which are the equivalent of cash.[67] Accounts and notes receivable due from and recognized by solvent debtors are deemed to be the equivalent of cash. Only in exceptional cases would accruals of uncertain or indeterminate items be sanctioned by

[66] Postponement of collection by reason of moratorium does not entitle taxpayer to omit income from accounts so affected from return for year in which received. (C. B. 4, page 98; O. D. 869.)

[67] See page 383.

good accounting practice. The definitions of income in the law and regulations are strictly limited by the decisions of the United States Supreme Court. These decisions do not require the payment of tax on transactions which are not the equivalent of cash. Any regulation which attempts to set aside this theory is not sound.

RULING. The United States brought suit against the M Corporation for the recovery and possession of oil lands. A receiver was appointed to take possession of the lands and retain the proceeds of the sales of oil and gas produced thereon, pending a final judgment, which was rendered in 1919 in favor of the United States. Pursuant to an Act of Congress the United States in 1920 leased the land that was involved to the same corporation. Later, pursuant to the same Act, the Department of Justice proceeded with the settlement and adjustment of the judgment against the company, whereupon by a decree of the court rendered in 1921, the receiver was directed to pay a part of the impounded money to the M Company, which is held to be taxable income for the year 1921, when it was paid. (B. 39-21-1839; O. D. 1046.)

Award of damages by arbitration board.—

RULING. The award in the year 1918 by a board of arbitration of x dollars to the M Company on its unliquidated claim to a portion of the proceeds arising out of transactions which took place in 1917 is income to the corporation for the year 1918 rather than 1917. . . . . (C. B. 2, page 82; S. 1335.)

In computing damages the element of value at March 1, 1913, must not be forgotten. In the case of damages for infringement of patents, etc., it is quite possible that suits not yet settled, or those which have been settled during recent years, include payments which properly apply to the period prior to March 1, 1913.

RULING. Certain property owned by an estate was in 1906 listed by a city to be condemned for public purposes. The property was not destroyed until 1917. During that year a verdict was rendered awarding the estate x dollars, with interest at the rate of 6 per cent per annum from 1906, the date the property was listed for condemnation. Mandamus proceedings were instituted to enforce the settlement of this award, and in 1920 the estate received payment of the

face value of the claim, together with interest accrued since 1906, and costs.

Held, that the measure of taxable income is the excess of the sum of the principal and accrued interest actually received over the fair market value of the claim representing such principal and interest accrued as at March 1, 1913. Such excess as regards the principal of the claim is taxable as of the year 1920, in which it was received. The amount of the interest received is exempt from income tax as interest on the obligation of a political subdivision of a State within the meaning of section 213 (b) 4 of the Revenue Act of 1918.

The cost of mandamus proceedings was a replacement of the amount expended by the estate in the collection of a debt and should not be included in gross income of the estate. Nor should it be taken as a deduction in computing net income for the year in which expended. (C. B. 3, page 113; O. D. 591.)

A taxpayer sued in 1908 to recover damages for patent infringement and in 1911 a United States circuit court rendered a decision in his favor. The case was referred to a master, who filed a final report with the court early in 1918. In the latter part of 1918, the case was compromised, and an amount agreed upon was paid to the taxpayer. The Treasury held: ". . . . the amount received in 1918 does not constitute taxable income for that year, for the reason that the right to receive this amount existed and was a part of the assets of the X Company on March 1, 1913."

Claims.—The word "claims" indicates that liability is disputed. If claimants do not accrue the claims as income and if those against whom claims are made deny liability, it can hardly be held that taxable income arises unless and until there is realization of the equivalent of cash.

It is now well settled that proceeds from claims, judgments, contracts, etc., definitely ascertained and vested before March 1, 1913, although received during some subsequent year, are not taxable net income.[68]

Bad debts.—When accounts or notes receivable have been

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[68] See Arts 51 and 151, Chapter XXX.

charged off because they are deemed to be worthless, it is proper to include any subsequent collections on account thereof as taxable income of the year in which realization occurs. It is not good accounting practice to reopen the accounts of previous years under such circumstances; nor is it proper to reopen tax returns under similar conditions. Even if it develops subsequently that poor judgment is used and some accounts which were charged off should not have been charged off, it would bring about indescribable confusion in accounting and tax matters if it were permissible to reopen the accounts except under extraordinary circumstances. Business is conducted under ordinary conditions and superhuman knowledge is not imputed to business men. Under the accrual system books of account must be closed and income statements prepared periodically; when reasonable care is taken in closing books, subsequent adjustments must be made in subsequent accounts.

Types of Business Income Taxable and Non-Taxable

Taxable income can only arise from dealings with the public.—The types of business dealings here considered are with the public generally. For purposes of convenience organizations are sometimes set up which operate as separate entities, but are entirely owned by one interest. Reference is not made to the relationship which exists between parent and subsidiary corporations or between affiliated corporations. Such relationships are discussed elsewhere.[69] But there are other cases in which a firm or an individual establishes branch houses or agencies which keep separate sets of books and prepare independent profit and loss statements. If the separation is in form and not in substance income tax returns should not be made except by the sole owner.

An English firm had an agency in the United States which purchased cotton in the United States and shipped it to England. The cotton was billed to the head office at market

[69] See Chapter XXII and page 196.

prices on the day of shipment. A book profit of several hundred thousand dollars was shown on the books kept in this country. No cotton was shipped to any one except the actual purchasers. Not a dollar of actual profit was realized in this country. An income tax examiner held that a taxable profit was realized because it was shown on the books. The profit was a book profit only. No net income was realized. Upon appeal the inspector was overruled.

Charging or crediting oneself at high or low prices cannot produce a profit or a loss. Dealing with the public is necessary to produce profit or loss.

RULING. Coal purchased by a company on bona fide contracts entered into prior to October 30, 1919, and shipped to tidewater for export on contracts entered into prior to that date was diverted by a Government agency for the use of certain railroads and the company is carrying these accounts on its books awaiting a decision by the Government as to the final settlement of the bills.

Held, that the principle laid down in the last two sentences of article 52, Regulations 45, is applicable in this case, although these sentences refer to the unusual conditions prevailing at the close of 1918. The M Company should set up these accounts in a "Suspense Account" and eliminate them from their returns for 1919 and 1920, pending final settlement. There should be attached to such returns a full statement of the facts relative to the claims of the company on account of the diversion of the coal. When final settlement has been made, amended returns for the years 1919, and 1920, should be filed, including therein the income found to be due upon such final settlement. (C. B. 4, page 93; O. D. 816.)

The foregoing ruling attempts to apply the very doubtful provision of article 52[70] of Regulations 45 to an unrelated matter. In the foregoing case the shippers had accounts receivable at the end of 1919 and 1920. If the accounts were not bad at the end of these years they could not, under the regulations, be charged off. There is no basis in the 1918 regulations for "eliminating" doubtful accounts. A proper interpretation of the laws would have permitted charging off bad debts,[71] but the regulations specifically forbade it. The invoking of article

[70] See page 513.
[71] Chapter XXX.

52 is versatile but unsound. If permitted to stand it will bring about a vast number of amended returns and the inclusion in the accounts of subsequent years of the amount, if any, recovered.

RULING. In 1914 the United States Government took over a certain business of the M Company and held it until March, 1920, at which time it was returned to private ownership. In 1919, following the settlement of a dispute as to the corporation entitled to receive the income from the operation of the business, the United States Government paid the M Company the sum of $2x$ dollars representing earnings from 1914 to April 6, 1917. In 1920 it paid the company x dollars as rental from April 6, 1917, to March, 1920.

The question arises as to how this income should be reported and also the manner and extent a claim for depreciation in value of the property may be made.

Held, that inasmuch as the M Company kept its books on the cash receipts and disbursements basis, the amounts received in 1919 and 1920 must be treated as income for these years. (C. B. 4, page 180; O. D. 948.)

The foregoing ruling is not consistent with the Treasury's contention that unusual conditions are sufficient to modify general rules. It may be assumed that if the government "took over" and "held" the business from 1916 to 1920, failure during such period to keep accounts on an accural basis is the failure of the government and not of the taxpayer. The government cannot take advantage of its own negligence to keep accounts of property held in trust according to good accounting methods.

Gifts received by corporations not taxable as income.[72]—

LAW. Section 213. [Individuals] . . . . **"gross income"— . . . . (b) Does not include . . . . (3) The value of property acquired by gift, bequest, devise, ...**

Section 233. [Corporations] . . . . **"gross income" means the gross income as defined in section 213, ...**

The foregoing section of the law applies to corporations as well as to individuals. The interesting question arises: How shall a corporation enter gifts on its books? If the

[72] **[Former Procedure]** For procedure under 1909 and 1913 laws, see *Income Tax Procedure*, 1920, pages 322-323.

values at date of gift are set up in the books, subsequent gains based on book values may or may not be taxable. It would seem to be necessary in all of such cases to ascertain from the donors the cost to them of the property donated and to note the cost in the ledger account. The maximum tax which can be imposed upon the net income of corporations after January 1, 1922, is 12½ per cent. Individuals who own property for less than two years and who desire to sell it, apparently can donate the property to a corporation. When the corporation sells it the gain can be taxed only at the 12½ per cent rate.

The Treasury has held that upon the recision of a contract and repayment to the corporation by an employee of compensation paid under the contract in a prior year, such payment was a gift to the corporation. (See O. D. 1075, quoted on page 430.)

Sale by corporation of property acquired by gift.—

LAW. Section 202. (a) . . . . (2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the same time of such acquisition; . . . .

Forgiveness of indebtedness.—

REGULATION. The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is

realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.[73] . . . . (Art. 50.)

One of the United States circuit courts of appeals has decided in a recent case that a debt forgiven is *not* income to the debtor.[74] The court said: "Now, it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital . . . . The cancellation of the debt was a means of contribution to its capital account, quite as though the money had been contributed by the stockholder only to enhance the value of his stock."

It is suggested that when stockholders or bondholders contemplate making good a deficit, attention should be given to both sides of the transaction. The creditor may desire to claim credit for the transaction as a bad debt deduction.

Outlawed accounts held to be taxable income.—

DECISION. (Syl.) The amount of obligations of a railroad corporation carried on the books as liabilities, which became outlawed and were therefore written off during the taxable years 1910 and 1911, represented profit to the company which was properly included in its net income for the year in which so written off.[75]

Voluntary assessments paid by stockholders not taxable.—

REGULATION. Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its stockholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there

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[73] [Former Procedure] The last sentence of the corresponding article (51) in Reg. 45 (1919 Edition) reads: "If, however, a corporation to which a stockholder is indebted forgives the debt, the transaction has the effect of the payment of a dividend."

[74] *U. S. v. Oregon-Washington R. & Nav. Co.*, Circ. Ct. of App., 251 Fed. 211 (April 24, 1918).

[75] *Great Northern Ry. Co. v. Lynch*, U. S. Dist. Ct., Dist. of Minnesota, 3rd Div., January 10, 1921, (not reported). See T. D. 3147.

is no increase in the outstanding shares of stock of the corporation. The payments in such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual stockholders, and will be treated as an addition to and as a part of the operating capital of the company. . . . . (Art. 544.)

If the payments are made as indicated the stockholders must consider the payments as capital investments. If the corporation is losing money and the stockholders are merely advancing funds with which to pay its debts or losses it might be better to arrange the payments in the form of advances. Failure of the corporation to repay would entitle the stockholders to charge off the advances as bad debts.

Taxes paid by vendee for vendor on profits from sale of property are income to vendor.—

Ruling. A vendee of a business agrees that in addition to the purchase price of the business he will pay the income and excess profit taxes of the vendor arising from the sale of said business. (Query.) Does the payment of the said taxes by the vendee constitute income to the vendor which the vendor would have to report on his income tax statement and pay a tax thereon?

(Answer.) Income, excess profits and war profits taxes paid by vendee for vendor on profits from sale of property to vendee constitute additional taxable income to vendor. (Telegram of inquiry from The Corporation Trust Company, and the reply thereto signed by Commissioner Daniel C. Roper, and dated May 2, 1919.)

An agreement to pay an additional sum to a vendor equal to the tax payable by him is an enforceable contract, but the calculation is a somewhat involved one. The amount payable must be sufficient to pay the tax on the profit plus such additional sum as will enable the vendor to pay the tax on the amount received in excess of the original sales price.[76] The vendee would properly consider that the tax which is paid for the vendor is a part of the purchase price of the property.

[76] For computations, see *Income Tax Procedure*, 1921, pages 382, 383.

It is understood that the Treasury has not in all cases adhered to the foregoing position.[77]

Net proceeds of "business" life insurance are not income.—The proceeds of "business" life insurance are not to be included in gross income.

LAW. Section 213. . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured;[78] . . . .

LAW. Section 233. (a) That in the case of a corporation . . . . the term "gross income" means the gross income as defined in section 213. . . . .

REGULATION. . . . .Under the revenue act of 1921, the proceeds of life insurance policies paid upon the death of the insured to any beneficiary (corporate or otherwise) are not to be included in the beneficiary's gross income. . . . . (Art. 541.)

Although the premiums paid on "business" life insurance are still not deductible when the taxpayer is a beneficiary,[79] the entire proceeds of such policies may be excluded from gross income.

RESERVE FUND TO CARRY OWN INSURANCE.—Premiums collected from customers and placed in a reserve fund by an automobile dealer to provide for losses through confiscation, under the Volstead Act, of automobiles sold by him on term contracts, are income in the taxable year in which they are received or accrued.[80]

Of course payments made or liabilities contracted in respect of such premiums are allowable deductions.

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[77] A. R. M. 16, C. B. 2, page 62 is reversed.

[78] [Former Procedure] Under all laws prior to 1921, the proceeds of life insurance collected by corporations were included in gross income. Section 213 (b-1) of the 1918 law contains the limiting clause, "to individual beneficiaries or to the estate of the insured." Under the 1918 law the premiums paid on "business" life insurance were offset against the gross amount received on the policies, and the remainder was required to be reported as taxable income.

[79] Section 215 (a-4).

[80] Bulletin 47-21-1929; O. D. 1106.

Income from instalment proceeds of "business" life insurance.—

Ruling. The option exercised by a corporation beneficiary in allowing the proceeds of an insurance policy to be paid in installments represents in fact an investment of such proceeds. Any interest or profits received over and above the face value of each installment represents taxable income to the corporation for the year in which received. (C. B. 1, page 211; O. D. 66.)

Bonus received in stock.—

Regulation. . . . . Where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.[81] . . . . (Art. 39.)

This article is equitable and accords with good accounting practice.

Purchase by corporation of its own bonds at a discount.— When a corporation purchases its own bonds at a discount it is clear that the retirement of the bonds discharges a liability at less than book value, with a resulting credit to surplus.

Regulation. (1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (*a*) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face

[81] **[Former Procedure]** Reg. 33, Art. 44, provided that "the entire proceeds derived from the sale or transfer of such (bonus) stock is income subject to the normal and additional tax."

value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year. . . . . (Art. 545.)

It will be noted that the conditions precedent in the foregoing are purchase and retirement. A corporation which buys some of its bonds in the open market at less than par and carries them at cost as marketable investments and has no intention of retiring them cannot be held to have realized a profit. The burden of proof is on the corporation to show that the bonds were not retired. If the bonds were resold at a profit, it would be taxable; if resold at a loss it would be deductible.

It has been held that taxpayers' own obligations in the form of corporate bonds are not susceptible of valuation at March 1, 1913, for the purposes of establishing gain or loss from sale or exchange.[82]

Profit on purchase by corporation of its own stock not taxable.—Corporations sometimes purchase their own stock at a price less than par value. If the stock is retired or if it is carried as an asset on the corporation's books at par, the difference between par value and cost should be credited to surplus account. On this point the regulations provide as follows:

REGULATION. . . . . If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase of its own stock.[83] . . . . (Art. 543.)

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[82] Bulletin 27-21-1717; A. R. R. 545.

[83] **[Former Procedure]**

REGULATION. "Treasury stock, wherever and whenever that term is used in connection with the accounts of the corporation or for income tax purposes, will be held to mean stock which had been previously issued

RULING. When a corporation transferred certain assets having a book value in excess of the book value on the same date of its capital stock acquired by such transfer and carried to treasury stock account, there took place a capital transaction and not one in which there resulted a loss from the sale, exchange, or other disposition of property. (B. 51-21-1984; A. R. R. 693.)

CRITICISM OF FOREGOING REGULATION.—If a corporation were to resell treasury stock at a profit, as is frequently done, there would be no real difference between this transaction and one involving the purchase and sale of the shares of another corporation. When stock is donated or sold to a corporation at a nominal price to enable the corporation to secure working capital the resale of the treasury stock may in fact represent capital and if so the proceeds of the sale are not properly taxable. But if the stock is purchased as an investment any resale at a profit should be held to be a taxable transaction.

TREASURY STOCK—ACCOUNTING PROCEDURE.—In order that stock may be considered as full-paid and non-assessable, and thus provide a means whereby it may be legally sold by the corporation at less than its par value without liability attaching to the purchaser for the difference between the price paid and par, arrangements are frequently made to issue capital stock for property or services in an amount in excess of the actual cash value of such property or services. A part of such stock is then "donated" to the corporation and is thereafter dealt with as "treasury stock." When sold, the proceeds are sometimes treated as income, but the usual and proper disposition is to credit an account called "Capital surplus" or

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by the corporation and which had been repossessed by it through purchase or otherwise and then carried on its books as an asset. If such stock is resold at a price in excess of its cost upon repossession, such excess shall be returned as income for the year in which resold. Unissued stock, which had been retained by the corporation for the purpose of future sale, will not, for the purpose of the income tax, be considered 'Treasury stock' and when sold no part of the proceeds of such sale will be considered taxable income. Nor will there be any deductible loss if such stock is sold at a price less than par." (Reg. 33, 1918, Art. 98.)

"Working capital," or, better still, to credit the proceeds directly to the property or asset account.

Of course, the amount realized for the donated stock is capital. By a fiction, induced by improper incorporation laws, it is made to appear that on one side the stock is issued for value received at $100 per share, and that on the other side someone who has paid the alleged full value for it hands it back to the corporation as a gift, pure and simple. The courts are supposed to go to the substance of a matter and to ignore the form; but it is questionable if they should be asked to declare as capital what a corporation itself denominates as income. Therefore, the corporation should be careful, in handling the proceeds of the sale of treasury stock on its books, to indicate clearly the fact that the so-called income is actually capital.

Accounting practice is as follows:

If purchased by the corporation for resale, cost price is the correct basis of book entry; if purchased without specific intention to resell and more than par is paid, the premium should be charged to surplus. In effect, part of the surplus is paid to the retiring stockholder. The par value of the stock purchased should be deducted on the balance sheet from the total stock issued. When the cost is less than par, the purchase price should be carried in the books and in the balance sheet as an asset, but the item must not be included among any other assets. It is desirable that the number of shares should be stated. It is information which should be revealed. Many published balance sheets do show all details, but the practice is not uniform.

If acquired by gift, opinions differ as to the form of entry. Because of the legal formalities required to show that the stock has been issued full-paid, the best authorities sanction the setting up of the stock as an asset at par value, offsetting this entry by the creation of a reserve or surplus account which is designated as a capital item, and which is clearly differentiated from the surplus which arises out of profits or which is available for dividends. It is never proper to include any part of the book value of treasury stock among the current profits or as a part of the surplus available for dividends. This does not apply, however, if stock had been resold at a profit and the profit is realized in cash. As treasury stock is sold or otherwise disposed of, the asset account is credited and an adjustment is made between this account and the reserve or surplus account for the difference between the book value and the proceeds of the sale.[84]

[84] *Auditing, Theory and Practice* (1921 edition), by R. H. Montgomery, pages 206-207.

The Treasury now requires "copies of the journal entries covering the original issuance, repossession and any subsequent adjustments," if treasury stock was "on hand at any time during the taxable period."[85]

Discount for cash not taxable.—

Ruling. Reference is made to your letter of the 15th instant, in which you state that a corporation has purchased a large quantity of equipment and in consideration of making a prompt payment therefor has been allowed a cash discount. You ask to be advised whether or not this discount should be reported as income.

In reply you are informed that the discount allowed to the corporation purchasing this new equipment need not be reported as income, but the cost of the equipment as charged to capital must represent only the net cost after making allowance for the discount in question. (Letter to E. G. Shorrock & Co., Seattle, Washington, signed by Deputy Commissioner L. F. Speer, and dated November 26, 1918.)

This ruling is in accord with what the author believes to be good accounting practice,[86] but opinion on the point is divided.

Income from Export Business

A domestic corporation chiefly engaged in buying goods in the United States and shipping them to foreign countries and there selling them, having been taxed upon its corporate income from all sources, sued to recover that proportion of the tax compulsorily paid which its foreign business bore to its whole trade, upon the ground that a tax on income derived from the profitable sale of exported articles was a tax on the articles so exported, and therefore unconstitutional. The Supreme Court of the United States (May 20, 1918), in holding that the corporation was taxable upon its entire income, used the following language.[87]

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[85] Instructions page 2, schedule E 10, form 1120.

[86] *Auditing, Theory and Practice* (1921 edition), by R. H. Montgomery, page 587.

[87] *Peck and Co. v. Lowe*, 247 U. S. 165, 38 S. Ct. 432, 62 L. Ed. 1049.

DECISION. . . . . It (the income tax) is not laid on articles in course of exportation or on anything which inherently or by the usages of commerce is embraced in exportation or any of its processes. On the contrary, it is an income tax laid generally on net incomes. And while it cannot be applied to any income which Congress has no power to tax (see *Stanton v. Baltic Mining Co.*), it is both nominally and actually a general tax. It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income. The words of the act are "net income arising or accruing from all sources." There is no discrimination. At most, exportation is affected only indirectly and remotely. The tax is levied after exportation is completed, after all expenses are paid and losses adjusted, and after the recipient of the income is free to use it as he chooses.

Sales covered by open drafts.—Many exporting firms at the close of 1920 had made sales to customers in foreign countries. In view of many cases of refusal to accept shipments, the question arises whether or not to report the profit on such sales as taxable income when—

1. Drafts are due but consignee has not accepted.
2. The goods are in transit and advices are not due.

Proper procedure is to treat the sales as not completed and to inventory such goods at cost or market value, whichever is lower, on the spot where they happen to be. However, drafts accepted and advices received up to the time of filing the tax return should be included as sales and deducted from the inventory.

Income from Government Contracts

The 1921 law re-enacts the provision of the 1918 law which differentiates in several particulars between net income from business in general and net income derived from government contracts. The latter term is defined thus:

LAW. Section 2. . . . . (11) The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any

of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this subdivision, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.[88]

The purpose in earmarking income from government contracts was to place upon it in years after 1918 a heavier burden of tax than that imposed upon income not derived from war activity. The 1918 profits tax rates apply to such income if received in 1921.

Most of the rulings issued by the Treasury on specific cases have involved the question of time, *i. e.*, was there a contract in force between the dates specified in the law, viz., April 6, 1917, and November 11, 1918? This is a legal question, and the Treasury's conclusions in each case are susceptible to revision by the courts.

The Treasury has also ruled[89] that so-called "order contracts" on which the work was done by order of the President under the Naval Appropriation Acts of March 4, 1917, and July 1, 1918, are "government contracts." This ruling, however, is open to serious question,[90] and will no doubt be contested in the courts.

RULING. A corporation which contracted with another corporation to manufacture and deliver machinery to be used in manufacturing ammunition, but did not produce or furnish ammunition or any component part thereof, nor perform any direct service in connection with the production of ammunition manufactured by another corporation under contract for the United States Government, is not a subcontractor within the meaning of Section 1, Revenue Act of 1918. (C. B. 2, page 12; O. D. 359.)

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[88] For method of allocating income from government contracts, and computation of tax thereon, see *Excess Profits Tax Procedure*, 1921.

[89] C. B. 2, page 13; O. D. 477.

[90] See *Excess Profits Tax Procedure*, 1921.

SUPPLEMENTAL CONTRACTS HELD TO BE GOVERNMENT CONTRACTS.—

RULING. Supplemental contracts made with a department of the United States Government after November 11, 1918, modifying original contracts entered into between April 6, 1917, and November 11, 1918, between the same parties, are "Government contracts" entered into between April 6, 1917, and November 11, 1918, within the meaning of the Revenue Act of 1918 and the income therefrom is taxable under section 301 (c) of the above Act. (I-2-16; Sol. Op. 128.)

Form of contract not enforcible.—

RULING. A contract between the Government and a corporation which was entered into and enforceable against the corporation prior to April 6, 1917, but which was not executed in the form prescribed by section 3744, Revised Statutes, so as to become enforceable against the Government until after that date, is not a "Government contract" within the meaning of that term as defined in the Revenue Act of 1918, and the corporation will not be required to compute its tax upon the profits arising therefrom in accordance with section 301 (c) of that act. (C. B. 2, page 13; O. D. 412.)

Corporations subsidiary to or affiliated with others.—The 1921 law provides that corporations which are affiliated shall make consolidated returns[91] for 1921 "subject to the same conditions as provided by the Revenue Act of 1918." Under the 1918 law [section 240 (b)] an affiliated corporation, 50 per cent of whose gross income was derived from government contracts, is denied the privilege.

1918 LAW. Section 240. (a) That corporations which are affiliated . . . . shall . . . . make a consolidated return . . . . : *Provided*, That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income. . . .

[91] Section 240 (e).

Corporations in great numbers placed their facilities unreservedly at the disposal of the government. Because certain corporations were guilty of actual and despicable profiteering, there is no justification for a general penalty which will reach many corporations which deserve credit rather than punishment. The guilty ones should be punished in some other way.

RULING. The income of affiliated corporations which is derived from Government contracts is taxable (except as provided in sec. 240(a) of the Revenue Act of 1918) upon the basis of the total sum received from that source by the group and not upon the basis of the separate amount received by each corporation. (Also Art. 635.) (C. B. 2, page 226; O. D. 415.)

Beginning with January 1, 1922, affiliated corporations may make either separate returns or a consolidated return. Since the higher rate of tax imposed on government contract income is for excess and war profits tax only, and the profits tax is repealed as of December 31, 1921, the "government contract" provisions will not affect income received in 1922 and subsequent years.

May not qualify as a personal service corporation.—The privilege of qualifying as a personal service corporation (which means reporting as a partnership) is denied to a corporation, under certain circumstances.

LAW. Section 200. . . . . **(5) The term "personal service corporation" . . . . does not include . . . . any corporation 50 per centum or more of whose gross income consists . . . . (2) of gains, profits, commissions, or other income, derived from a Government contract, or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. . . . .**

Amortization allowances should be credited to plant accounts.[92]—

REGULATION. . . . . All allowances made to a taxpayer by a

[92] **[Former Procedure]** Article 181 of Regulations 45 reads as follows: REGULATION. ". . . . All allowances made to a taxpayer by a contracting department of the Government, or by any other contractor, for

contracting department of the Government, or by any other contractor, for amortization, specifically as such, shall be treated as a reduction of the cost of the taxpayer's plant investment. Further amortization is allowable only in respect of such reduced cost. . . . . (Art. 181.)

The foregoing regulation is sound and is in accord with good accounting and business methods. It reflects the actual procedure of most taxpayers.

The method of determining the proper deduction for amortization is fully discussed in Chapter XXXII, "Deductions for Extraordinary Obsolescence and Amortization."

Former procedure has been materially modified by the new regulations. Such items as claims for compensation under canceled government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined.

REGULATION. Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. Such items as claims for compensation under canceled Government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined. (Art. 51.)

The foregoing procedure now accords with practice regarding similar claims.

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amortization, or fall in the value of property, whether such allowances were made as a part of the price of the product or in settlement of claims arising out of the cancellation or termination of contracts, shall be included in gross income. . . . " (Reg. 45, Art. 181.)

The regulation was misunderstood and occasioned much difficulty.

[Former Procedure]

Government contract adjustments.—

REGULATION. ". . . . In view of the unusual conditions prevailing at the close of the year 1918 it is recognized that many items of gross income, such as claims for compensation under cancelled contracts, together with claims against contracting departments of the Government for amortization and other matters, while properly constituting gross income for the taxable year 1918 were undecided and not sufficiently definite in amount to be reported in the original return for that year. In every such case the taxpayer should attach to his return a full statement of such pending claims and other matters, and when the correct amount of such items is ascertained an amended return for the taxable year 1918 should be filed." (Reg. 45, Art. 52.)

At the end of 1918, many taxpayers having claims against the government were unable to evaluate such claims because of the inability of government representatives to state the basis of settlement. This does not refer to claims which were disputed by the government, but to claims which were admitted to be due.

If a contractor included in gross income for 1918 a larger or smaller amount as due from the government than has been actually collected, the book profit or loss shown in 1919 is in some cases not an actual profit or loss, but represents a mere adjustment of an estimate as of December 31, 1918. In such cases the proper procedure is to file an amended return for 1918.

The Treasury, however, must be consistent. If it insists on reopening returns for 1918 in order to write back additional profits, when such profits have been determined in subsequent years, it must also allow the reopening of 1917, 1918 or 1919 returns when subsequent determination proves that excessive profits were returned in one or more of those years. It is of course obvious that there is a limit to the reopening of old returns, otherwise taxpayers and the government would indulge in a never-ending competition. Books of account are closed, and always have been closed, on estimates which are more or less inaccurate. A reopening is justified only when a mistake has been made. and the obligation upon a taxpayer to reopen when a mistake is discovered is the same whether it means additional tax or less tax. The reopening of accounts for the purpose of recomputing inventories is much more reasonable than a requirement that accounts for 1918 be reopened in order to include as income disputed claims against the government.

It may be expected that the foregoing procedure will be modified in the light of article 51, Regulations 62, although many additional assessments have been made on the basis of the old regulations. Taxpayers should ask for reconsideration when excessive assessments have been made.

In a recent case, the Treasury at first denied a loss in 1919 because of a government contract adjustment made in 1920, but subsequently permitted the reopening of the 1919 return and the reduction of the 1919 income from Government contract because of its "tentative" character.

RULING. " . . . . The Committee is of the opinion that the loss result-

ing from the company's claim was due more to an overestimated charge tentatively set up on the books of the company, and that any subsequent loss sustained on the account was more properly a charge to surplus when the amount of the settlement was finally decided. In this case it would seem that the company would have been perfectly within its rights in accordance with article 52, Regulations 45, if it had withheld from its return for the fiscal year ended June 30, 1919, the full amount of its claim against the Government pending a final settlement, which it was known would be definitely decided at a later date by the District Claims Board. It would seem, therefore, that the disallowance of the loss resulting from an erroneous charge in 1918 would be a discrimination against the company and a penalty for the apparent good faith displayed in including as a taxable profit an amount which at the time of filing its return was unquestionably in doubt. . . . ." (B. 48-21-1948; A. R. R. 685.)

The Treasury also stated that "all claims in the final analysis were more or less tentative and subject to a revision by the government.

CHAPTER XVI

INCOME FROM SALES AND EXCHANGES OF SECURITIES AND OTHER PROPERTY

To determine the amount subject to tax in the case of an appreciation of property, a comparison must be made between the value as established at the beginning of the period, and the value at the end of the period as established by the price for which the property is sold or exchanged.

If an exchange of property for other property results in a continuing transaction, no gain or loss occurs at the time; if the transaction is closed it is taxable or not taxable, depending on the bases of value and their application to the closed transactions; these bases will be discussed in Chapter XVII. The following sections of the 1921 law deal with exchanges of property for other property.

LAW. Section 202. . . . . **(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—**

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. . . . .

What Constitutes a Closed Transaction?

When an outright sale is made for cash no problem exists; but transactions vary by imperceptible degrees from the outright sale for cash through various sorts of trades and exchanges to the transaction in which the property is too indefinitely valued to afford a basis for claiming that a "realization" has been made. It is here that serious problems of procedure arise. When is a sale a true sale in the sense of being a closed transaction rather than merely a continuing one?

Previous attempts of the Treasury to answer this question have been conspicuously unsuccessful. The 1921 law provides two definite tests. In order to constitute a closed and taxable transaction the property received in exchange must have:

1. A readily realizable market value, *and*
2. A different form or use.

Therefore, exchanges of like property, or of securities in the reorganization[1] of corporations, are continuing transactions, in which there is as yet no taxable gain or deductible loss.

REGULATION. Gain or loss arising from the acquisition and subsequent disposition of property is realized only when as the result of a transaction between the owner and another person the property is converted into other property (*a*) that is essentially different from the property disposed of, and (*b*) that has a readily realizable market value. . . . . . (Art. 1564.)

[1] For full discussion of reorganizations, see page [illegible].

(1) Property received in exchange must have a readily realizable market value.—The exchange of property sections of the 1921 law may be regarded as interpretative of former laws rather than as expressing new principles of taxation. In the 1918 law[2] appear the words: "The equivalent of cash to the amount of its fair market value, if any." The average man sees no distinction between these words and the language of the new law.

LAW. Section 202. . . . . **(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; . . . .**

REGULATION. . . . . Property has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property. In other words, the property received in exchange must be readily marketable at substantially its fair value in order that a gain or loss be recognized. Property which is regularly traded in in a public market has a readily realizable market value in the quantities regularly traded in. Property may be salable, as in the case of a forced sale or in exceptional quantities, without having a readily realizable market value. Stock in a close corporation may or may not have a readily realizable market value, depending upon all the facts in each particular case. The question whether property has a readily realizable market value, and if so the amount thereof, is one of fact to be determined in each case in the light of all the surrounding circumstances; and attention should be called in the return to each exchange effected during the taxable year about which there could be any doubt. (Art. 1564.)

The first test stated in the law is a simple one, and the words, "readily realizable market value," should be strictly construed in favor of the taxpayer as would reasonably have been expected under the 1918 law.[3]

Some of the court decisions go so far as to say that gains or income must be realized in cash before they can be taxed,

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[2] See section 202 (b), page 569.

[3] **[Former Procedure]** Under the 1918 and prior laws the Treasury held that many transactions were closed (and therefore taxable) which were not so under any reasonable interpretations of the laws. For prior laws, regulations and rulings, and comments thereon, see *Income Tax Procedure*, 1921, pages 434-485.

but it is not necessary to go so far. Taxpayers will be content if the actual income and not the unrealized income should be taxed. It might be urged that if a taxpayer were permitted to continue to exchange or trade securities which are not readily realizable without being required to report such transactions for income tax, he might in the course of time run up a "shoestring" to a million dollars without having paid a cent of tax thereon. This is, of course, true, but such a person would be in no more favorable position than the person whose property appreciates to a like degree without being exchanged back and forth from hand to hand.

The 1921 law effects a compromise and taxes gains when the property exchanged has "a readily realizable market value," and is not "of a like kind." An exception is also made in the case of reorganization.[4] The author's contention is that this value should be something more definite than a guess or even a value imputed from an occasional market quotation for similar property. The tax should rest upon a substantial foundation.

Stating the rule affirmatively, it is held that an exchange will be taxable (if the securities or other property received are worth more than cost or March 1, 1913, value) when (a) the exchange is into property essentially different from the property disposed of, and (b) where there is a readily realizable market value. Both factors must be present.[5]

In discussing additional articles of the regulations it is most important to keep in mind the basic principles involved. Unless readily realizable market value can be ascribed to what is received, the property received need not be evaluated at the time of exchange. An account receivable, contract, agreement, option or similar undertaking upon which a suit at law can be maintained, if it has a market value, as options frequently have, might be taxable. If it could not be transferred or hypothecated, it could hardly be said to have a readily realizable market value.

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[4] See page 557.

[5] Section 202.

Meaning of "readily realizable market value."—A full discussion of the meaning of the term "fair market value or value March 1, 1913,"[6] appears elsewhere and need not be repeated here.

In article 1564, the term "fair value" is used as a measure by which to determine whether a conversion is into property having a "readily realizable value." The terms "fair value," "market value" and "fair market value" have been used by the Treasury in many cases interchangeably.

In dealing with the problem under the 1918 law the obvious purpose of the successive changes in the regulations dealing with exchanges of property has been to make as many closed transactions as possible.[7]

The use of the term "readily realizable market value" presupposes an *actual* market. Property may be of great value, but there may be no "market" for it. Central Park in New York and the Treasury Department Building in Washington certainly are valuable, but there is no market for them. There is no willing buyer and no willing seller.

The framers of the law do not intend that a tax shall be imposed in respect of the "value" of the property received, but only in respect of its fair market value when determined in the usual way which must, however, also be readily realizable. Only in case there are both willing buyers *and* willing sellers is there a fair market value.

The following interpretation by the Treasury of the term "fair market value" throws some light on what we may expect when it comes to the interpretation of "readily realizable market value."

Ruling. In the absence of reason to the contrary the words, "fair market value" must be given their ordinary meaning. The expression "market value," either with or without adjective "fair," is a familiar one and has frequently been defined and explained. Without attempting in this recommendation to collate these definitions, it may be said that they amount in substance to this, that the "market value"

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[6] See page 500.

[7] *Income Tax Procedure*, 1921, page 461.

of property is the fair value of the property in money as between one who wishes to purchase and one who wishes to sell. It is not, however, what can be obtained for the property when the owner is under peculiar compulsion to sell or the purchaser to buy; nor is it a purely speculative value which an owner could not reasonably expect to obtain for the property although he might possibly be fortunate enough to do so. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective "fair" emphasizes the idea of fairness inherent in this conception of market value, and excludes any possibility of a construction of the words "market value" with reference to a market in which, or to circumstances of sale under which, for any reason a fair price could not be obtained. Under this interpretation property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell, and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion; that is, property has no "fair market value" when market conditions are such that there would be no trading in the property in question at a fair price. It does not follow, however, that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The fact that there is no "market price" or "current price" so established does not indicate that the property may not readily be sold at a fair price, and the meaning of "market value" is not ordinarily so restricted. The courts have recognized, not only that there are cases in which property has no "market value," or more properly "market price," in this restricted sense, but also that there are cases in which property has no "market value" in the broader sense in which the words are used in the statute as herein construed. See Wall *v.* Platt (169 Mass., 398); Montgomery County *v.* Schuylkill Bridge Co. (110 Pa. St., 54).

A construction of the statute in which the words "fair market value" are defined as above indicated is in accord with its theory and purpose. A fundamental consideration in income taxation is to determine when income, or elements essential to the computation of income, such as gain and loss, are realized. Clearly, gain or loss is realized upon the sale of property for cash. It seems, moreover, that even apart from express statutory provision gain or loss is realized from the exchange of property for other property which may fairly be said to be the equivalent of cash. See California Copper Syndicate *v.* Harris (41 Scot. L. R., 691; 5 Tax Cas. 159). Such

was the ruling of the Bureau under the Revenue Acts of 1913 and 1916 (see Law Opinion, 434), and the Revenue Act of 1918 expressly recognizes this principle in the language now under consideration in providing that "the property received in exchange shall . . . . be treated as the equivalent of cash." It is reasonable to regard property which has a "fair market value," as the words are herein defined, as "the equivalent of cash." A taxpayer receiving such property can determine the amount of his gain or loss in terms of cash with a reasonable degree of certainty and can, if necessary, without undue sacrifice obtain by the sale of such property cash with which to pay his taxes. It is, however, unreasonable to regard property which has no "fair market value," in this sense, as "the equivalent of cash." A taxpayer receiving such property can neither determine the amount of his gain or loss with certainty nor obtain cash by sale of the property without sacrifice.

It may be argued against the construction here given to the words "fair market value" that these words are used in other parts of the statute in such a way as to imply that property always has a "fair market value" and that the same meaning should be given to the words throughout the statute. Thus, in ascertaining gain or loss upon the sale or other disposition of property acquired before March 1, 1913, the basis is "the fair market price or value of such property as of that date" (sec. 202(a(1)), or, where stock or securities acquired before March 1, 1913, are exchanged for other stock or securities in connection with a reorganization, merger, or consolidation, "the fair market value as of that date" (sec. 202(b)). So in ascertaining the amount of depletion in the case of property acquired before March 1, 1913, the basis is the "fair market value . . . . on that date," and in the case of property having a discovery value the basis is the "fair market value of the property at the date of the discovery, or within 30 days thereafter." (Sec. 214(a) (10); 234(a) (9).)

The provisions above quoted raise no necessary implication that property always has a "fair market value." The resort to "fair market value" in the case of discovery can be made only where the "fair market value of property is materially disproportionate to the cost"; that is, it must appear that the property has a "fair market value" and that such value is materially disproportionate to cost. There is no presumption that either fact exists. In the case of depletion of property acquired before March 1, 1913, "fair market value" is to "be taken in lieu of cost up to that date." The natural construction of this language is that "fair market value" is to be taken wherever possible, otherwise "cost up to that date." In ascertaining the gain or loss resulting from the sale or other disposition of property the purpose of valuing such property on March 1, 1913, is to determine the amount which must be withdrawn from the sale price

in order to keep the capital intact. In the case of a sale or other disposition of property, not, however, including depletion (see Stanton *v.* Baltic Mining Co., 240 U. S., 103), it would be necessary to so withdraw the value of the property on March 1, 1913, even if there was no statutory provision therefor. See Doyle *v.* Mitchell Bros. (247 U. S., 179); Lynch *v.* Turrish (247 U. S., 221); Southern Pacific Co. *v.* Lowe (247 U. S., 330). The present statute must be construed as authorizing the withdrawal of such value. This result can be reached either by holding that all property had a "fair market price or value" on March 1, 1913, or by holding that "fair market price or value" is the statutory measure of the value to be withdrawn in any case in which the property has a "fair market price or value," but that where it has no such "fair market price or value" other means of measuring value must be resorted to. The latter interpretation gives to the words "fair market . . . . value" their ordinary meaning, and, while recognizing that they have the same meaning throughout the statute, gives effect to the words "if any" in the paragraph under consideration. It seems, therefore, the more reasonable.

(Since "fair market price," if not synonymous with "fair market value" is narrower in its scope, it seems unnecessary to distinguish between the expression "fair market price or value" and "fair market value." While it is possible to construe the words "fair market" as modifying only the word "price" and not the word "value" in section 202(2), the use of the phrase "fair market value" in other parts of the statute seems to indicate that this is not the proper construction. It may be noted, however, that if this construction were adopted the same result would be reached as is reached on the lines developed in this recommendation.)

Some practical bearings of the construction herein given to the statute should be noted. Statements herein made are, however, far from exhaustive of a subject of special difficulty in the application of a general principle to specific cases. In determining whether property has a "fair market value" all available evidences must be considered. A case in which property has no "fair market value" should be regarded as unusual, and a determination that property has no "fair market value" should not be made lightly. Property is not without "fair market value" merely because there is a considerable divergence of opinion as to its value. "Fair market value" is to a large extent a matter of opinion and men of equally wise judgment will differ widely in their opinions. Frequently excellent evidence as to the "fair market value" of property, especially that which, though not ordinarily traded in, has a value in use, is found in its cost, or in the cost of reproducing it, with adjustments for depreciation and the like. (It should be noted, however, that while cost is frequently excellent evidence of "fair market value," "fair market

value" may be either greater or less than cost and must, wherever made the statutory test, be taken regardless of its relation to cost.) As already pointed out, property can not be said to have no "fair market value" merely because no price therefor is established by public sales or sales in the way of ordinary business. Of course it is not essential that property be listed or traded in on any exchange in order that it may have a "fair market value." For example, stock in a small closely held corporation does not *ipso facto* lack "fair market value," nor does article 1563 of Regulations 45 so hold. Evidence as to the assets and liabilities of such a corporation and as to its earnings may furnish very definite indications as to its "fair market value." Even if a corporation is newly organized and has never done business as such, but has succeeded to the business of an individual or partnership, its stock will ordinarily have a "fair market value" ascertainable by reference to its assets and liabilities, the history of the specific business, and the history and conditions of the industry in general. Similar considerations apply to other kinds of property.

In any case in which it is found that property received in exchange has no "fair market value" and that, consequently, no gain or loss results from the exchange, the property received in exchange is to be treated as taking the place of the property exchanged therefor and takes as its value for the purpose of computing depreciation, depletion and gain or loss resulting from sale or other disposition, the cost, or the market value on March 1, 1913, or on the date of discovery, as the case may be, of the property exchanged for it. Property which has no "fair market value" for the purpose of determining gain or loss under section 202 (b) has no "fair market value" for any of the purposes of the Revenue Act of 1918.[8]

It is held, therefore, that section 202 (b) of the Revenue Act of 1918 must be construed as recognizing that there are exchanges of property for other property which do not result in taxable gain or deductible loss for the reason that the property received in exchange has no "fair market value." A general statement as to the circumstances under which this is true is made in the body of this recommendation. (C. B. 1, page 40; T. B. R. 57.)

The foregoing ruling was issued in 1919 at a time when the Treasury was interpreting 1918 and prior laws very strictly. The provisions of the 1921 law regarding exchanges are not essentially different from the 1913, 1916 and 1917 laws, but are more detailed. The ruling is inserted at this

[8] This statement need not be considered as changing the procedure as to values at March 1, 1913, because the law specifically provides that "value" at that date may control, whereas in exchanges there *must* be "readily realizable market value."

point as indicating the position of the Treasury under the provision of prior laws.

Illustration of a closed transaction.—

Regulation. . . . . (4) A owns certain property which he transfers to corporation X, a going concern, in which A owns no stock, in exchange for common stock of the corporation of the par value of $170,000. The X corporation has outstanding immediately after the transfer common stock of the par value of $200,000 and nonvoting preferred stock of the par value of $50,000. A realized a gain or loss from this exchange measured by the difference between the basis of the property exchanged and the fair market value, if readily realizable, of the stock received in the exchange. If the property exchanged was acquired prior to March 1, 1913, see article 1561.[9] (Art. 1566.)

Example 4—Gain or Loss Is Imputed

	Common	Preferred Non-voting
Stock owned before transfer	....	......
Stock received for property	$170,000	......
Total stock owned after transfer...........	$170,000 (a)	...... (c)
Total stock outstanding after transfer......	$200,000 (b)	$50,000 (d)
Percentage (a) is of (b)	85%	
Percentage (c) is of (d)		.....

In the last illustration, if only $100 of preferred stock were outstanding, and the taxpayer owned that one share, no gain or loss would be imputed to the transfer of his property to the corporation, because he would then own at least 80 per cent of all classes of stock outstanding. The requirement that in addition to owning 80 per cent of the voting stock the taxpayer must also own "at least 80 per centum of the total number of shares of all other classes of stock of the corporation," in this case seems rather absurd. The language of the law is, however, explicit on this point and must obviously be complied with if the benefit of the section is to be had.

[9] See page 570.

(2) **Property of a different kind or use.**—Congress may be said to have gone the limit in freeing from tax all exchanges which do not result in realized income. The language of the law suspending the determination of taxable gain or deductible loss in the case of exchanges until there has been a change in both form and substance of the taxpayer's investment, is broad and susceptible of very liberal interpretation.

LAW. Section 202. . . . . (c) For the purposes of this title, on **an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—**

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use; . . . .

The Treasury regulation construing the words "like kind" reads as follows:

REGULATION. Where property is exchanged for other property, even if the property received in exchange has a readily realizable market value, no gain or loss is recognized;

(*a*) Where property held for investment is exchanged for other property of a like kind, or where property held for productive use in trade or business is exchanged for other property of a like use, the words "like kind" are defined as having reference to the nature or character of the property and not its grade or quality. Therefore under this paragraph no gain or loss is realized by one other than a dealer from the exchange of real estate for real estate, or from the exchange of evidences of indebtedness (such as bonds and notes) for evidences of indebtedness, or from the exchange of shares of stock for other shares of stock, but one kind or class of property may not, under this paragraph, be exchanged for property of a different kind or class, as shares of stock for bonds, or real estate for personal property. Where evidences of indebtedness are exchanged for other evidences of indebtedness, the fact that any of the evidences of indebtedness involved in such exchange are secured by mortgage or other lien, or the fact that any real estate involved in an exchange is improved or unimproved makes no difference, for such facts relate only to grade or quality of the property and not to its kind or class. There is excluded from the provisions of this paragraph stock-in-trade or other property held primarily for sale. Unproduc-

tive real estate held by one other than a dealer, for future use or future realization of the increment in value, is held for investment and not primarily for sale. (Art. 1566.)

It will be observed from the foregoing article that a most liberal interpretation is given of the property of "like kind" which may be made without either party to the transaction realizing any taxable income. Taking the regulation at its face value, it would appear that United States Steel stock, for instance, might be exchanged for shares of Pennsylvania Railroad without any taxable income resulting therefrom, even if the Steel stock had been purchased years before at a very low figure.

Unsecured notes may apparently be exchanged for mortgage bonds without any taxable profit (or deductible loss) arising from the exchange. Again, unimproved real estate may be exchanged for improved real estate, and vice versa.

It will be observed, however, that the Treasury distinguishes sharply between classes of securities, stocks and evidences of indebtedness (bonds, notes, etc.) not being deemed to be property of "like kind." Therefore, an exchange of United States Steel stock for Pennsylvania Railroad bonds would, under the Treasury's regulation, be deemed a closed transaction. The author fails to see the logic of the inhibition. If it is not a taxable transaction to exchange Steel stock for Pennsylvania Railroad stock, it is certainly not a taxable transaction to exchange certain kinds of stocks for certain kinds of bonds. The distinction, however, would not apply in cases of reorganizations where stock might be received in exchange for bonds or vice versa, even though the securities received might have "a readily realizable market value." Reorganizations are covered by a different subdivision of section 202 than exchanges of property of a "like kind or use."[10]

The Treasury regulation already quoted defines only the words "like kind" but makes no reference to the words "or

[10] See page 557.

use" which also appear in section 202 (c-1) of the law in the same connection. For instance, would the exchange of an automobile for a horse be deemed to be a continuing and not a closed transaction because both pieces of property are for "like . . . . use"?

It would defeat the whole purpose of an income tax law if taxpayers could exchange readily marketable securities or property of one class for wholly different property. The adoption of such a principle would in such cases result in the disappearance of money as a medium of exchange and the substitution of trading or bartering "in kind," such as goes on in Russia.

Article 1566 intimates that real estate dealers are not permitted to exchange one piece of property for another and to consider that the transaction is continuing. This is equivalent to stating that real estate dealers should inventory their properties. But real estate dealers have not been permitted to inventory their stock-in-trade as are other merchants; therefore the Treasury is estopped from treating them as dealers.[11]

Real estate dealers, like all other owners of investment property, will be taxed or not taxed on exchanges, depending on the factors which have been discussed. The exchange of one city lot for another city lot should be deemed to be a closed transaction, when the property received has a readily realizable value. It should not be held to be property of a like kind or use, any more than the shares of two steel companies or two railroad companies are held to be of the same kind or use.

One of the controlling factors in all such transactions is the intention of the parties; in almost all cases the question: "Is it a continuing or closed transaction?" can be settled by easily ascertainable facts. Section 202 is eminently fair and a reasonable administration of its provisions will not result inequitably.

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[11] See pages 486 and 545.

Sales Which May or May Not Result in Taxable Gains

In addition to completed transactions which are clearly taxable, there are other transactions which may or may not immediately be taxable, depending on their nature. Some transactions are on the border line, as discussed in article 1566.[12] The following classes of transactions may or may not be taxable.

When sale is made on instalment plan can tax be deferred?—In many cases of sales of property the seller attempts to arrange that the proceeds of the sale shall be received in instalments over a period of years, thus deferring the imposition of the tax. It is not feasible to discuss at length in this book arrangements of this nature. If the purchaser is not in good financial standing, or the seller retains title to his property, or the cash payments are distributed over a long period of years, the transaction certainly cannot be considered as closed. If the purchaser delivers his obligations to pay in such form as to render them the equivalent of cash, the transaction is a closed one and a tax will be imposed on the realized profit.

The owner of several magazines, who is said to have a net income of a million dollars a year, purchased a newspaper and gave five promissory notes in payment. The notes were for $100,000 each and matured annually for five years. The seller, who kept his books on the accrual basis, entered the notes as the equivalent of cash. In submitting his balance sheet to a federal reserve bank he was informed that he should not have included the notes as current assets. In the circumstances the Treasury could hardly hold that the notes were the equivalent of cash. In view of the rulings applicable to instalment houses and to sales of property on an instalment basis,[13] taxpayers need not consider that notes and other

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[12] See page 545.
[13] See Chapter XV.

securities are the equivalent of cash unless they can readily be discounted at a reasonable rate of interest.

If shares of stock are sold and delivery of part (and payment therefor) are postponed, the transaction should be deemed to be closed or not closed depending on the terms of the contract of sale.

Proceeds of sale of goodwill may be taxable.—When an individual or a partnership sells a business and its goodwill is an element, part of the purchase price is paid for goodwill, and the question arises as to the taxable status of the vendor. The question is not the same whether cash or securities are received, because in the former case there is a realization and the question settles down to the basis of the tax; in the latter case no actual realization, as a rule, takes place.

Assume that in 1921, A sold his business to B for $100,000 cash. The value of the net tangible assets was $50,000; the balance represented goodwill. A established the business in 1913, so no question of March 1, 1913, value arises. The Treasury would certainly tax A upon a basis of $50,000 realized profits, taxable at 1921 rates.

If A sells to a corporation for its stock it can hardly be expected that the stock he receives will be worth par value. Goodwill usually is valued on a hoped-for basis. Hopes are not taxable subjects. If A sells out to others, under the regulations he will be required to account for the fair value of the stock he receives. If he incorporates his own business he cannot be charged with receiving something he did not have before. Under the 1921 law [section 202 (c-3)] the transaction would be deemed a continuing one if A immediately after the transfer had 80 per cent control in the new corporation.[14] The regulations provide as follows:

REGULATION. Any profit or loss resulting from a sale of good will can be taken only when the business, or a part of it, to which the good will attaches is sold, in which case the profit or loss will be

[14] See page 536.

determined upon the basis of the cost of the assets, including good will. If the good will was acquired prior to March 1, 1913, the taxable gain or deductible loss should be ascertained in accordance with the provisions of article 1561. If specific payment was not made for good will acquired after February 28, 1913, there can be no deductible loss with respect thereto, but profit may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or fair market value on March 1, 1913, of the good will sold. (Art. 41.)

Are profits on sale of rights to subscribe to stock taxable?—One form in which appreciation in the value of property sometimes asserts itself, is the privilege given to a stockholder to subscribe to a new issue of stock upon particularly favorable terms. These "rights" in some cases undoubtedly represent an increase in the value of the stockholder's interest in the company, and under the 1918 regulations the Treasury attempted to tax the proceeds of the sale of such rights as income.

REGULATION. . . . . The entire amount realized from the sale of rights to subscribe for stock is income. (Art. 39.)

The Treasury in a lengthy opinion[15] relied upon the case of *Tax Commissioner v. Putnam*,[16] but in a recent case the court pointed out that that case was based on the theory that stock dividends were income and that under the federal law the gross proceeds from the sale of rights are not taxable.[17]

DECISION. There is apparently only one case which has passed upon the precise question here raised. Tax Commissioner vs. Putman, 227 Mass. 522. There the Government's position was squarely sustained, as was natural if not inevitable after the Court had held that stock dividends were taxable income, for while the returns from

[15] C. B. 1, page 72.
[16] 227 Mass. 522.
[17] *Safe Deposit & Trust Co. of Baltimore, Guardian of Frank R. Brown, v. Miles, Collector,* 237 Fed. 822, U. S. Dist. Ct. for the Dist. of Maryland, May 26, 1921. The position taken by the author had been that the proceeds from sale of rights was not all income. *Income Tax Procedure,* 1921, page 449.

rights are different things and may be income although such dividends are not, the reverse is scarcely possible.

If the stockholder must pay an income tax upon the full nominal amount of a stock dividend, he can hardly escape from paying upon all he gets from the sale of stock rights. It is impossible to be sure that the Supreme Judicial Court would have held the latter taxable, had it not first reached the conclusion that the former were. The express refusal of the United States Supreme Court to accept the ruling that stock dividends were income, necessarily deprives the Massachusetts case of persuasive force in the Federal Courts. Eisner v. Macomber, 252 U. S. 189-216. The question must therefore be dealt with as one upon which there is no direct authority. The reiterated declarations of the Supreme Court have, however, it is believed, made plain the principles which should govern its decision. What is taxable is the gain, profit or income derived from the sale or dealing in property, whether real or personal. 39 Stat. 757; 40 Stat. 300-307; Goodrich v. Edwards, decided March 28, 1921.

Congress, it is true, has very ample authority to adjust its income taxes according to its discretion, and the rules it prescribes for the ascertainment of taxable income are binding upon the Courts unless they are palpably arbitrary and unjust. LaBelle Iron Works v. The United States, decided May 16, 1921. The net revenue from some peculiar kind of property, such as mines, may include not only profit from operation, but a portion of the capital as well. The problems of apportionment may be too difficult and some of their factors too uncertain for adjustment by the Courts, and the tax may have to be assessed upon the entire net proceeds with such deductions only if any as Congress may have authorized. Von Baumbach v. Sargent Land Co., 242 U. S. 503. Nevertheless by and large the statute means what it says, and that is that the tax is to be levied on nothing else except gains, profits and income, and upon them only when actually realized in money or in money's worth, and in determining what is included therein, the Courts will look through form to substance. Doyle v. Mitchell Bros. Co., 247 U. S., 179; Eisner v. Macomber (Supra).

What are the facts to which these general rules are to be applied?

The shares of the Hartford Fire Insurance Company were worth on March 1, 1913, $760 apiece. At the time of the death intestate of the ward's father, the Government said that for the purpose of the estate tax, they were each of the value of $710 and that may be taken as their cost to the plaintiff. The Insurance Company determined to double the number of its shares and to give each of its stockholders the right, upon payment of $150 a share, to obtain as many new shares as he held old.

The plaintiff in the right of every share it held and which had cost it, as just mentioned, $710, could, by paying $150 a share more

get another, so that it would have two, which in the aggregate would have cost it $860 or $430 apiece. There would be no way of distinguishing between the old and the new. If the latter was something which had not before existed almost the same might as truthfully be said of the former. Its characteristics had undergone a great change. Before the issue of the new stock, it represented one twenty-thousandth of the capital of the company; afterwards it stood for but one forty-thousandth. Moreover, if the plaintiff had in person taken the new stock, and had had its old and new consolidated into one certificate, and had subsequently sold a part of its holdings it could not say that that with which it parted was out of the old or out of the new, or partly out of both. In determining the cost of its shares for the calculation of the profit or loss upon resale, it would be necessary to assume that they had one and all cost the holder an equal amount, which in the case of the plaintiff here was $430 a share.

It certainly could make no difference that without waiting until the stock was issued, and then selling, it sold the right to the new stock, and made it a part of the consideration that the buyer should assume for it the payment of the $150 per share exacted by the company. All that would have to be borne in mind in comparing the two ways of reaching the same end, is that if the right was sold, the price really received for the new share was $150 more than the sum paid to the seller, which in the case at bar was $358.48. That was equivalent to $508.48 for a fully-paid-for share, and the $78.48 by which it exceeded the $430 which the share cost the plaintiff, was the gain or profit it made out of the transaction.

That is the whole story. If $78.48 be multiplied by 35, the number of shares of rights sold by the plaintiff, the product will be $2,746.80, and upon that it was properly taxable and upon nothing more.

It still retains thirty-five shares. When, if ever, they, or any of them are sold, there must be returned as profit in the year in which the price is received for them, the amount, if any, by which that price exceeds $430.

It is of course immaterial that if the plaintiff had chosen at the time it parted with the rights to the other thirty-five, to sell any of those it still held, it would have made a taxable profit of nearly $80 a share upon those so disposed of. There is no tax upon a profit until that profit is realized.

Is an option taxable?—When a taxpayer receives a "right" to subscribe to stock or other securities and sells the right, the proceeds are held by the Treasury to be income.

When the right is not sold and the security is purchased

no income is deemed to accrue, even though the actual market value of the new security is greatly in excess of the option price, unless and until the security is subsequently sold at a profit. The theory is that no gain, profit or income has been *realized,* and that the accrual to the original investor is merely appreciation in value. There are, however, other kinds of rights or options which are in a different class. If a valuable option is received for services rendered, it could hardly be deemed to be a continuing transaction.

If a stockholder sold his stock for part in cash and part in an option to buy other property at a price considerably less than its fair market value, the option being assignable, it might or might not be a closed transaction.

It may be claimed that if an option is not exercised no profit can accrue, and so long as the option has not been exercised there has been no realization and it is not a closed transaction as defined by the regulations. The case is somewhat analogous to the receipt, as the proceeds of a sale, of a Liberty bond or currency, which later was lost or stolen. The proceeds or gain of the sale would never be realized in the sense of any permanent advantage to the taxpayer. He had the cash, but he lost it; and he had the option, which he might have sold, but did not.

Therefore, if an option can freely be sold at the date of receipt, it is probable that it will be taxed. Most options, however, cannot be deemed to be the equivalent of cash, and the exercise thereof constitutes a continuing rather than a closed transaction.

Exchange of insurance policies—calculation of profit.—

Ruling. In determining the taxable gain arising where a policyholder in a life insurance company relinquishes a policy held by him and takes a policy of another kind in exchange, it is held:

Where the second policy at the time of issuance has no readily determinable cash value, no taxable gain arises from the exchange.

Where the second policy at the time of issuance has a readily determinable cash value, and the value of the surrendered policy as of

March 1, 1913, *is greater* than the gross premiums charged prior to that date, less amounts returned, deducted or abated therefrom, the taxable gain, if any, arising from the exchange is the amount whereby (1) the sum of the value of the surrendered policy as of March 1, 1913, plus the gross premiums subsequently charged, less amounts returned, deducted, or abated therefrom, is exceeded by (2) the cash, if any, received upon surrender of the first policy, plus the cash value of the second policy.

Where the second policy at the time of issuance has a readily determinable cash value, but the value of the surrendered policy as of March 1, 1913, *is not greater* than the gross premiums charged prior to that date, less amounts returned, deducted or abated therefrom, the taxable gain, if any, arising from the exchange is the amount whereby, (1) the gross premiums charged at any time either before, on, or after March 1, 1913, less sums returned, deducted, or abated therefrom, are exceeded by (2) the cash, if any, received upon the surrender of the first policy, plus the cash value of the second policy. (C. B. 3, page 54; Sol. Op. 55.)

Sale of tax-exempt securities.—

RULING. Profit derived from State and municipal securities purchased at a discount is not taxable in the hands of the person holding such obligations at maturity except that in no case may such exemption exceed the total discount at which the securities were originally sold by the State or municipality.

Inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount), any person selling municipal bonds for an amount in excess of the cost of the bonds to him (or their fair market value as of March 1, 1913, if they were acquired prior to that date) realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount. (C. B. 3, page 49; O. D. 737.)[18]

No fault can be found with the foregoing ruling, since the law exempts only the interest from tax-exempt securities and not the profit derived from the sale thereof.

Sale of capital assets by a corporation.—When a corporation sells its assets for an amount in excess of their book value the corporation will be taxed on the excess. In turn the stockholders, when distribution is made, will be taxed

[18] Also see C. B. 4, page 31; O. D. 762; and C. B. 4, page 31; O. D. 774.

on the same amount, less the tax paid by the corporation. In order to avoid this double taxation the individual stockholders of the selling corporation should sell their stock to the new owner. When the purchaser acquires all the stock he or it may cause all of the assets of the corporation to be turned over for a nominal consideration. Thus the books of the corporation will not show any profit on the sale.[19]

RULING. If, upon the sale of the capital assets of a corporation to another corporation, shares of stock are surrendered by the old stockholders to the vendee corporation, the nature of the transaction is not changed from one of the sale by the corporation to one of sale of stock by the stockholders. (C. B. 2, page 81; A. R. M. 21.)

The ruling is highly technical. If the vendee corporation purchased the old shares directly from the *stockholders* or arranged an exchange with such stockholders, it could not be held that the vendor *corporation* made the sale. If the vendor corporation as a corporation foolishly arranged and made the

[19] [Former Procedure] The provision in the 1918 law (section 202) that the receipt of securities in a reorganization of a greater aggregate par value than that of the securities exchanged would be deemed to result in a closed transaction, has not been re-enacted.

REGULATION. In a case wherein a corporation acquires from stockholders the stock of another corporation, giving in exchange therefor its own stock, it is held that the transaction is one by which the corporation acquiring the stock becomes the sole stockholder of the other corporation. As a result of this transaction no income accrues to the corporation whose stock is thus acquired. Neither will any income accrue to this corporation if later the holding corporation should cause the assets of the underlying company to be transferred to it for mere nominal consideration. (Reg. 33, 1918, Art. 124.)

Although this regulation does not discuss the case of the individual shareholders who receive the stock of the purchasing company, it apparently holds that they are taxable on the basis of the "fair cash value" of the securities received. This situation is altered by the 1918 act in case the exchange is made "in connection with the reorganization, merger, or consolidation of a corporation," and in case the new stock is "of no greater aggregate par or face value" than the old. [Section 202 (b)].

The second edition of Regulations 45 stated that if less than 50 per cent of the stock of a new corporation were acquired in exchange for other property, the transaction would be deemed to be a closed one. Later, Art. 1566 of Reg. 45 was modified, holding that the exchange was a closed transaction only if the stock received had a market value.

sale and the stockholders merely *surrendered* their stock the old corporation would be subject to tax.

Reorganizations, Mergers and Consolidations or Exchanges which Are Not Closed and Taxable Transactions

The 1921 law in effect provides that taxable income does not arise from reorganizations,[20] even if the property received in exchange has a readily realizable market value, unless the security holders dispose of the securities received by them in the reorganization.

LAW. Section 202. . . . . (c) **For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized.**

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. . . .

SECURITIES EXCHANGED IN REORGANIZATION.—

REGULATION. Where property is exchanged for other property, even if the property received in exchange has a readily realizable market value, no gain or loss is recognized: . . . .

(*b*) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization" as used in this paragraph includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the outstanding voting stock and at least a majority of the total number of outstanding shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, however effected. Under this paragraph it makes no difference whether the stock or securities received are or are not of a

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[20] **[Former Procedure]** The taxation of gains or alleged gains arising from reorganizations prior to January 1, 1922, is a highly complicated and technical subject. For full discussion see *Income Tax Procedure,* 1921, etc. For rulings during 1921 see end of this chapter.

like kind or class. So long as the property received in the reorganization consists of stock or securities within the usual meaning and acceptation of these terms, no gain or loss is recognized. Where two or more corporations unite their properties, by either (1) the dissolution of corporation B and the sale of its assets to corporation A, or (2) the sale of its property by B to A, or (3) the sale of the stock of B to A, or (4) the merger of B into A, or (5) the consolidation of A and B, or (6) the acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, no taxable income is received from the transaction by A or B or by the stockholders of either corporation A or corporation B, provided the sole consideration received by the stockholders is stock or securities of corporations A or B or any corporation a party to or resulting from the reorganization. Where in connection with an internal adjustment of the affairs of a corporation, either by recapitalization or a change in identity, form, or domicile (however effected), a person receives in place of the stock or securities owned by him new stock or securities of the corporation, no gain or loss is realized. (Art. 1566.)

Definition of term "reorganization."—

Law. Section 202. . . . . (c) . . . . (2) . . . . **The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); . . . .**

The foregoing section means that exchanges are continuing transactions in the following cases:

1. Merger.
2. Consolidation.
3. Acquisition by one corporation of a majority of the voting stock Plus Majority of all other classes of stock — of another corporation.
4. Acquisition of substantially all the properties of another corporation.

5. Recapitalization.
6. Change in identity.
7. Change in form.
8. Change in place of organization.

Simply stated, if a taxpayer in a "reorganization" receives in exchange nothing but new securities, the transaction is not a closed one.

The foregoing may be summarized into two main groups, viz.:

1. Changes in substance and form which include classes 1 to 5; and
2. Changes only in form, which include classes 6 to 8.

Mergers and other forms of reorganizations.—The terms used in section 202 (c-2), viz., "merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization," include financial transactions in which usually there are changes in substance as well as in form. There is a loss and mingling of identity which may or may not assume a taxable status. As heretofore stated, no tax will be imposed if there is no readily realizable market value for the new securities or other property. No tax will be imposed if one corporation when it acquires an interest in another corporation secures at least a majority interest. No tax will be imposed when (a) transfers of property are made by an individual or a corporation to a corporation, or (b) when two or more individuals jointly or two or more corporations jointly convey property to a corporation, provided in the case of (a) the previous owner is in control and owns at least 80 per cent of all of the voting shares plus 80 per cent of all other shares of the new corporation. In case of (b) it is sufficient if the same affiliated group (individuals or corpora-

[21] See page 592.

tions) who conveyed the property, jointly own and control the 80 per cent interest.

Changes in substance and form.—The 1921 law makes it clear that exchanges of securities or other property, even though the securities received have a readily realizable market value, *may* not be taxable in cases where there is a change in substance. These cases depend almost entirely on the percentage of ownership in the properties which is retained by the old owners. When there is a change in substance, and the old owners do not retain a substantial interest in the new property, and there is a readily realizable market value for the new securities, it is entirely reasonable to consider the transaction a closed one.

NEW PROPERTY MUST HAVE READILY REALIZABLE VALUE.—Section 202 (c) provides that no tax will be imposed in any case when the property received has no readily realizable market value.

WHAT CONSTITUTES "LIKE KIND OR USE."—Article 1566 defining the words "like kind" has already been quoted and commented upon on page 545 *et seq.* in connection with the subject of closed transactions. Further comment on this point seems unnecessary, except that it should be noted that the exchange must be a 100 per cent one in order to avoid the possibility of tax. If part cash is received there may or may not be any tax, depending on the basis prescribed in section 202 (e).[21]

Transfer of property to a corporation.—

LAW. Section 202. . . . . **(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized.**

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. . . .

It will be asked, "What happens if in case of a transfer described in the foregoing section of the law the continuing interest is only 79 per cent?" The answer is not easy. If the new shares have no readily realizable market value, there is no tax. If the new shares have a readily marketable value, it means that ownership to the extent of 21 per cent has been disposed of and must be accounted for under section 202 (e), and it is deemed to be proper to consider the other 79 per cent the equivalent of cash. If there is a ready market, cash can be raised to pay the tax. In any event, any gain would no doubt be a capital gain and the rate of tax on capital gains is not excessive.

There will not be many instances of this kind to which tax liability will attach. The element of readily realizable market value is enough to eliminate from possible taxation 99 per cent of such transactions.

In any event, the 80 per cent provision applies only to the time "immediately after the transfer." Subsequent sales are not taxable unless the proceeds exceed the cost or March 1, 1913, value of the old securities.

It is difficult to reconcile the procedure laid down in section 202 (c-3) with section 202 (c-1). Under the latter section, when property is exchanged for other property of a like kind or use no tax is imposed. It would seem that when property is transferred to a corporation and 79 per cent ownership is retained, the conditions of section 202 (c-1) are fulfilled and that no taxable income can accrue (unless the proceeds from

the sale of the 21 per cent interest exceed the cost or March 1, 1913, value), because the proceeds will be credited against cost or value as provided in section 202 (e). Furthermore, section 202 (c-3) seems to conflict with section 202 (c-2). The latter deals with reorganizations, etc. It would seem to be possible for those who desire to form a new corporation, [section 202 (c-3)], to arrange to own and control at least 80 per cent of its stock "immediately after" its organization. The next step would be to consolidate with another corporation under section 202 (c-2), in which case it is only necessary to retain a majority interest in the new corporation. Even though the securities of the new corporation are readily marketable, no tax can be imposed.

Illustrations of continuing transactions.—

Regulation. . . . . (1) A and B each own an undivided one-half interest in certain property. Corporation X is created, to which A and B transfer the property, each receiving in exchange therefor 50 per cent of the stock of the corporation X. No gain or loss is realized from this exchange.

(2) A, who owns common stock in the X corporation of the par value of $70,000, transfers certain property to the corporation, for which he received additional common stock of the par value of $15,000. The X corporation has outstanding immediately after the transfer only common stock of the par value of $100,000. No gain or loss is realized from this exchange.

(3) A owns certain property which he transfers to the corporation X, a going concern, in which he owns common stock of the par value of $280,000 and class A nonvoting preferred stock of the par value of $190,000. A receives in exchange for the property common stock of the par value of $70,000. The X corporation immediately after the transfer has outstanding common stock of the par value of $400,000, class A nonvoting preferred stock of the par value of $200,000 and class B nonvoting preferred stock of the par value of $25,000. No gain or loss is realized from this exchange. . . . . (Art. 1566.)

In (1) there is no gain because the old interests own and control more than 80 per cent of the new corporation.

In (2) the continuing interest is 85 per cent.

In (3) the continuing interest is 86.4 per cent.

In statement form, examples (2) and (3) given in the foregoing regulation appear as follows:

EXAMPLE 2—NO GAIN OR LOSS IS IMPUTED

	Common (par value)	Preferred, Class A Non-voting (par value)	Preferred, Class B Non-voting (par value)
Stock owned by individual before transferring property	$ 70,000		
Stock received by individual for property transferred	15,000		
Total stock owned by individual after transfer	$ 85,000 (a)		
Total stock outstanding after transfer	$100,000 (b)		
Percentage (a) is of (b).........	85%		

EXAMPLE 3—NO GAIN OR LOSS IS IMPUTED

Stock owned before transfer......	$280,000	$190,000	......
Stock received for property......	70,000	....	......
Total stock owned after transfer..	$350,000 (a)	$190,000 (c)	......
Total stock outstanding after transfer	$400,000 (b)	$200,000 (d)	$25,000 (e)
Percentage (a) is of (b).........	87.5%		
Pencentage (c) is of (d) plus (e).........		84.4%	

In the foregoing illustration, if the taxpayer held $175,000 of class A preferred stock, instead of $190,000, he would be denied the benefit of the reorganization provision. He would control 87.5 per cent of the common stock, and 92.5 per cent of the class A preferred, but his preferred holding would be only 77.8 per cent of the total of both classes of preferred outstanding.

PURCHASE OF ASSETS BY BONDHOLDERS.—It frequently happens that bondholders, in order to protect themselves, purchase outright the property represented by their bonds, or exchange their bonds for stock in a reorganized company which purchases the assets of the old corporation. In such cases the assets may be transferred to a new corporation and

no tax will be imposed if the assignors retain more than 80 per cent of the stock of the new corporation.

Disposition of surplus of dissolved corporation.—Practically all reorganizations and consolidations result in the dissolution of pre-existing corporations. Taxpayers who receive cash or securities arising from the dissolution of a corporation should inquire as to whether or not the old corporation had an undistributed surplus account on its books. If so, such surplus as and when distributed to stockholders in dividends (or the equivalent of dividends) was free from all tax as to the part accumulated prior to March 1, 1913, and free from the normal tax as to the part earned after March 1, 1913.[22]

Dissolution of limited partnerships.—The procedure in the case of dissolution of limited partnerships of the corporation type[23] is the same as that for corporations. When there is a large surplus at the date of distribution, it must be borne in mind that the normal income tax has been paid on all accumulations since March 1, 1913. If securities in a new corporation or limited partnership are received in exchange, it would be regarded as a distribution in kind and no tax would be imposed unless and until the securities were subsequently disposed of by the individual partners.[24]

If the old partnership distributes the new securities to its shareholders, the transaction will be deemed a continuing one, under section 202 (c-3).[25]

Changes in form.—Section 202 (c-2) of the 1921 law groups changes in identity, form and place of organization with reorganizations generally, which are not taxable even though the new securities have a readily realizable market

[22] See Chapter XXII as to dividends.
[23] See Chapter XXIV.
[24] See Chapter XXIV.
[25] See page 560.

value. The requirement that a substantial interest be retained in the new securities, hardly applies to mere changes in form, since the new ownership is usually precisely the same as the old.

Under previous laws the Treasury has held that very slight changes in corporate entities result in closed transactions and subject the owners of the so-called new securities to tax. The 1921 law definitely settles the question for the future and may be used as interpretative of the past.

[Former Procedure]

Under the 1918 law an exchange of property was regarded as a closed transaction (a) if the property received was the "equivalent of cash," except that (b) if securities were received in a reorganization of "no greater aggregate par or face value" than those exchanged, the transaction was deemed not to be closed; (c) if the aggregate par of the securities received in a reorganization was greater than the par of those exchanged, the transaction was deemed to be closed.

The gain in (a) was the excess of the "fair market value" of the property received over the cost or March 1, 1913, value of the property exchanged.

The gain in (c) was (1) the excess par value of the securities received in exchange over the par of those exchanged, or (2) the excess "fair market value" over the cost or March 1, 1913, value, respectively. That is, the taxable profit is (1) or (2), whichever is lower.

The subject is treated at great length in *Income Tax Procedure*, 1921, in Chapters XIV and XV. Space does not permit the inclusion of old rulings and comments in this volume. The following rulings were issued in 1921.

Ruling. The provisions of section 202 (b) of the Revenue Act of 1918, relating to reorganizations, consolidations, and mergers, are new. These provisions are not contained in any of the prior income tax Acts and they are not declaratory of the rule existing under the previous Acts. They apply to the determination of gain or loss from exchanges of stock or securities in connection with reorganizations, consolidations, or mergers, occurring only in 1918 and subsequent years. It has been the uniform practice of the Department under the prior income tax statutes in dealing with all exchanges of stock in one corporation for stock in another corporation to recognize the different entities and to regard the stock received in exchange as essentially different property from that disposed of. Under those statutes this office has consistently held that gain or loss arises from such transactions if the stock received in the exchange has a market value even though the aggregate par value of the stock received in the exchange is not greater than the aggregate par value of the stock parted with. (C. B. 4, page 45; O. D. 783.)

The foregoing ruling sets forth the separate entity theory of the Treas-

[Former Procedure—Continued]

ury as applied to 1917 and prior laws. The courts have not yet decided the issue squarely. In the *Phellis* (*U. S. v. Phellis*, advance opinions, 66 L. Ed., page 69), *Rockefeller* (*Rockefeller v. U. S.*, advance opinions, 66 L. Ed., page 74), and other cases the new securities were held to be of a different character than the old. On the whole, the trend of the court decisions seems to support the principle that an exchange of securities results in a taxable transaction when there is a real market value for the new securities.

Effect of the receipt of cash and stock of greater par value.—

RULING. Upon the liquidation of a corporation in 1919 and the formation of a new one a taxpayer exchanged stock of the old corporation purchased subsequent to February 28, 1913, for a certain amount in cash and stock of the new corporation having an aggregate par value in excess of the aggregate par value of the old stock. The old stock cost the taxpayer more than the fair market value of the new stock plus the cash received.

It is held that the exchange of stock may be treated as a closed transaction and that the taxpayer may take as a loss the difference between the cost of the old stock and the fair market value of the new stock plus the cash received. (B. 28-21-1722; O. D. 970.)

Income from common stock exchanged for preferred.—

RULING. An individual traded his common stock purchased since February 28, 1913, to another individual for preferred stock in the same company. Gain or loss was realized by reason of the exchange. This gain or loss was measured by the difference between cost of the common stock and the fair market value of the preferred stock as at the date of exchange. (B. 35-21-1788; O. D. 1008.)

PAR VALUE OF STOCK IN FOREIGN CORPORATION AS DETERMINED BY RATE OF EXCHANGE.—

RULING. Where in connection with a reorganization, consolidation or merger, stock in a domestic corporation is exchanged for stock in an English corporation, the par value of the latter being expressed in pounds, in order to determine whether the stock received is of a greater par value than the stock exchanged, the par value of the stock in the English corporation should be expressed in terms of United States money based on the rate of exchange in effect at the date of such reorganization, consolidation or merger. (B. 41-21-1859; O. D. 1058.)

RULING. In 1917 a domestic corporation purchased tangible property in a foreign country for a stated sum in the currency of that country at an exchange rate of $0.20. Later in the same year the property was transferred to a newly organized corporation of the same foreign country in exchange for its capital stock of a total par value equal to the same amount as the cost of the tangible property, the rate of exchange at the time of the transfer being $0.30.

Held, that gain or loss was realized by the domestic corporation through the exchange of the property for stock of the new foreign corporation in the amount that the fair market value of such stock in American money at the time of such exchange was greater or less than the cost of the property in American money. (C. B. 4, page 46; O. D. 1670.)

The foregoing ruling carries a temporary fluctuation in exchange rates

[Former Procedure—Continued]

into a transaction in fixed assets. It is doubtful if a loss would have been allowed under similar circumstances.

For effect of fluctuation of exchange rate on par value in case of exchange of stock of a domestic corporation for that of a foreign company, see B. 41-21-1859; O. D. 1058.

Par value imputed to subscriptions to joint-stock company.—

Ruling. The M Company, organized pursuant to a State statute, is a joint-stock company. The net value of its assets on March 1, 1913, was approximately x dollars. Its net assets on December 31, 1920, were approximately $5x$ dollars. The company proposes to incorporate and to transfer all of the property and assets of the joint-stock company to a corporation which would assume all liabilities. The corporation will issue to the members of the joint-stock company shares of stock of a par value equal to the value of the net assets transferred to the corporation.

Advice was requested as to whether the members of the joint-stock company would be subject to a tax on the difference between the value of their respective interests in the joint-stock company as of March 1, 1913, and the value of the shares of stock of the new corporation, issued in exchange therefor. Held, that section 202 (b) and article 1567, Regulations 45, are applicable in the case of a reorganization into a corporation of a joint-stock company which is taxable under the Revenue Act of 1918 as a corporation.

Held further, that if the par value of the shares of stock of the corporation so received is in excess of the par value of the stock or subscriptions to the joint-stock company, such excess will be taxable gain to the recipient to the extent that the fair market value of the new stock received by him is in excess of the cost of his stock or subscriptions (or if acquired prior to March 1, 1913, the fair market value as of that date if greater than cost). (B. 40-21-1851; O. D. 1051.)

CHAPTER XVII

COMPUTATION OF TAX ON EXCHANGES OR SALES OF CAPITAL ASSETS

The Supreme Court of the United States has decided that appreciation of property, accrued since March 1, 1913, and *realized,* is taxable under an income tax law.[1] The 1921 law provides, however, that capital net gains[2] realized after December 31, 1921, may be taxed at only 12½ per cent.

Just prior to the passage of the 1921 law, the Treasury ruled that appreciation accrued *prior* to March 1, 1913, but realized in a subsequent year, is income (although not taxable) of the year in which realized, and is not the realization of taxpayers' capital at March 1, 1913.[3] This interpretation did not result in the taxation of the realization by a corporation, but it did result in the taxation of dividends paid out of such gains. The 1921 law, however, contains a provision which specifically states that "any . . . . increase in value of property accrued prior to March 1, 1913, may be distributed exempt from tax . . . ." to the recipients of such dividends.[4]

The chief defect in the past procedure governing the taxation of these gains was the attempt to tax profits which were not definitely realized. The Treasury stated that gains or profits would not be taxed until realized.[5] Of course it so stated, otherwise the levy would have amounted to a direct tax on property—not an income tax—and such a direct tax is unconstitutional unless apportioned according to population.

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[1] *Walsh v. Brewster,* advance opinions, 65 L. Ed. 451.

[2] **[Former Procedure]** Under all laws prior to that of 1921, capital gains were taxed at the same rates as other net income. For full discussion of capital net gains see page 627.

[3] The interpretations also affect invested capital. The rulings are overruled by the new regulations, see page 715 *et seq.*

[4] Section 201 (b).

[5] See page 536.

Having decided that gains or profits arising from capital transactions are taxable, the tendency of the Treasury under laws prior to 1921 was to tax every such gain, both those actually realized and those which were merely apparent.[6] This tendency is illustrated by the Treasury rulings dealing with the question whether or not the exchange of securities constitutes a closed transaction.[7] As a matter of fact, most of such exchanges do not result in realizations. It may be readily admitted that if a man buys a share of inactive stock for $10 and later exchanges it for a share of United States Steel stock which is selling at $100, there is so near a realization of $90 in cash that there can be little objection to assessment of the tax. The theory that a newly acquired security can always be sold at current market quotations is sometimes fallacious, however, even when applied to listed stocks or bonds. In the case of unlisted or closely held securities the lack of a free market usually makes it unfair if not impossible to consider an exchange a closed transaction. Moreover, it is fallacious to assume that the transfer or sale of a few shares (out of many) constitutes a free market.

The changes in the 1921 law are not as radical as they appear to be. They are radical when compared with the regulations under which prior laws were administered. The author believes that the inhibitions in the 1921 law against taxing apparent gains arising from exchanges, reorganizations, etc., should be looked upon as interpretations of the meaning of the term "closed transactions." If this is a correct inference, many of the rulings prior to 1922 defining the term must be revised. Taxpayers who actually continued their interests

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[6] **[Former Procedure]** In the 1921 and prior editions of this book the author exhaustively commented on the propriety of taxing capital gains. Numerous American and British authorities were cited. The author consistently supported the position that capital gains accruing after March 1, 1913, were taxable. In view of the decision in *Walsh v. Brewster* (advance opinions 65 L. Ed. 451) and other cases the matter is now of only academic interest. Those who are interested in the development of the subject should consult *Income Tax Procedure,* 1921, pages 394-402.

[7] See page 536 *et seq.*

in capital assets but who have been taxed under the theory that they sold and repurchased the assets, have legal claims for refund of taxes assessed and paid.

Basis for Ascertaining Gain or Loss When Appreciation of Property Values Is Realized

The new law makes numerous changes in the basis for determining gain or loss when appreciation is realized.[8] The two main bases are cost (for property acquired after February 28, 1913) and fair market value at March 1, 1913, (for property acquired prior thereto). The various exceptions are succinctly stated in the law under the two main classifications of property acquired after and before March 1, 1913.

When property is acquired after February 28, 1913.—

LAW. Section 202. **(a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; . . . .**

The exceptions noted in the statute are:

1. Property which is properly subject to inventory.[9]
2. Gifts, after December 31, 1920.[10]
3. Property acquired by bequest, devise or inheritance.[11]

When property is acquired before March 1, 1913.—

LAW. Section 202. . . . . **(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a)** [that is to say, cost is the basis]; **but—**

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

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[8] **[Former Procedure]** For text of 1918 and prior laws, regulations thereunder and criticisms of the regulations, see *Income Tax Procedure*, 1921, pages 404-425.

[9] Section 202 (a-1). See page 457.

[10] Section 202 (a-2). See page 622.

[11] Section 202 (a-3). See page 625.

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income. . . .

The foregoing follows the decision of the Supreme Court,[12] retroactive to 1913. If an excessive tax has been paid on a basis other than that indicated by the above quoted section of the law, claim for refund should be made.

For discussion of gains arising from exchanges [section 202 (c)], see Chapter XVI.

Regulation. For the purpose of ascertaining the gain or loss from the sale or exchange or property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain to be included in gross income is the excess of the amount realized therefor over such fair market value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or loss is recognized in the case of property sold or exchanged (*a*) at more than cost but at less than its fair market value as of March 1, 1913, or (*b*) at less than cost but at more than its fair market value as of March 1, 1913. In any case proper adjustment must be made in computing gain or loss from the exchange or sale of property for any depreciation or depletion sustained and allowable as a deduction in computing net income; the amount of depreciation previously charged off by the taxpayer shall be deemed to be the true depreciation sustained unless shown by clear and convincing evidence to be incorrect. What the fair market value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear. In the case of property traded in on public exchanges, evidence of actual sales at or about March 1, 1913, or other basic date, affords evidence of value, but it must not be regarded as conclusive. The nature and extent of the sales and

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[12] *Goodrich v. Edwards*, U. S. Sup. Ct., March 28, 1921, advance opinions, 65 L. Ed. 450.

the circumstances under which they were made should be considered. Prices received at forced sales or for small lots of property may be and often are no real indication of the value of the amount of property in question. For instance, sales from time to time of a small number of shares of stock is little indication of the value of a large or controlling interest in the corporation. As to inventories, see section 203 of the statute and articles 1581-1588. As to sale of stock upon which dividends have been declared, see articles 1543, 1544, and 1546. The fair market value as of March 1, 1913, has no bearing on the determination of the invested capital of a corporation for the purpose of the war profits and excess profits tax. . . . . If the taxpayer can not determine the cost of securities purchased prior to March 1, 1913, because of the loss, destruction or failure to keep records, the value of the securities at the date or approximate date of acquisition may be used in determining the cost basis for purposes of computing the gain or loss from the sale of the securities. When the date or approximate date of acquisition is unknown, no general rule can be stated for determining the cost value of such securities. Each case must be considered separately upon its own facts. (Art. 1561.)

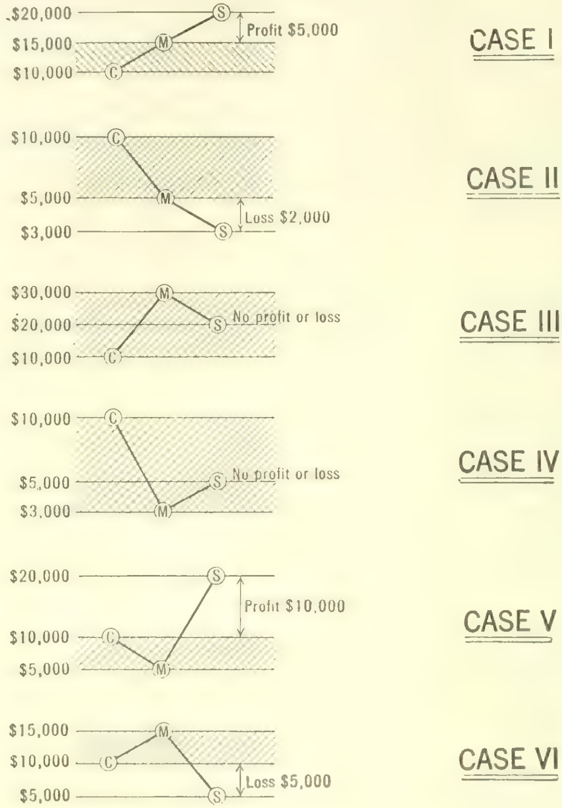
The following illustrative examples, given in article 1561, indicate the application of the law quoted above:

Case	Cost	Market Value at March 1, 1913	Sale Price	Taxable Profit or Deductible Loss
I	$10,000	$15,000	$20,000	$5,000 profit
II	10,000	5,000	3,000	2,000 loss
III	10,000	30,000	20,000	....
IV	10,000	3,000	5,000	....
V	10,000	5,000	20,000	10,000 profit
VI	10,000	15,000	5,000	5,000 loss

The following rules for determining taxable profit and deductible loss on property sold after March 1, 1913, which had been acquired prior to that date, are of interest:

1. There is neither a taxable gain nor a deductible loss when the selling price lies between cost and market value as of March 1, 1913.
2. When selling price is greater than both cost or market value, or when less than both cost or market value, the taxable gain or deductible loss is the lesser amount by which the selling price differs from cost or market value as of March 1, 1913.

The chart reproduced below shows in graphic form how the appreciation is measured.



EXPLANATION

C = COST PRICE, M = FAIR MARKET VALUE AS OF MAR. 1, 1913, AND S = SELLING PRICE

THE DIFFERENCE BETWEEN C AND M IS A ZONE OF NO PROFIT OR LOSS, AND HAS BEEN SHADED IN THE DIAGRAMS ABOVE.

IF THE SELLING PRICE FALLS WITHIN THIS AREA, THERE IS NO TAXABLE GAIN OR LOSS.

IF THE SELLING PRICE IS OUTSIDE THE SHADED AREA, THE GAIN OR LOSS IS MEASURED ONLY FROM THE NEARER MARGIN OF SUCH AREA.

The official illustrations given above, however, do not show the effect of depreciation accrued from March 1, 1913, to date of sale, which must always be considered.

REGULATION. . . . . In every case, however, in ascertaining the gain, the cost of the assets, including any expenditures properly charged to capital account, or the fair market value as of March 1, 1913, of the assets acquired prior thereto, should first be reduced by the amount of depreciation, obsolescence, depletion sustained and allowable, as a deduction in computing net income. . . . . (Art. 546.)

It is necessary to compare cost depreciated to date of sale with selling price, as well as to compare value at March 1, 1913, depreciated to date of sale with selling price.

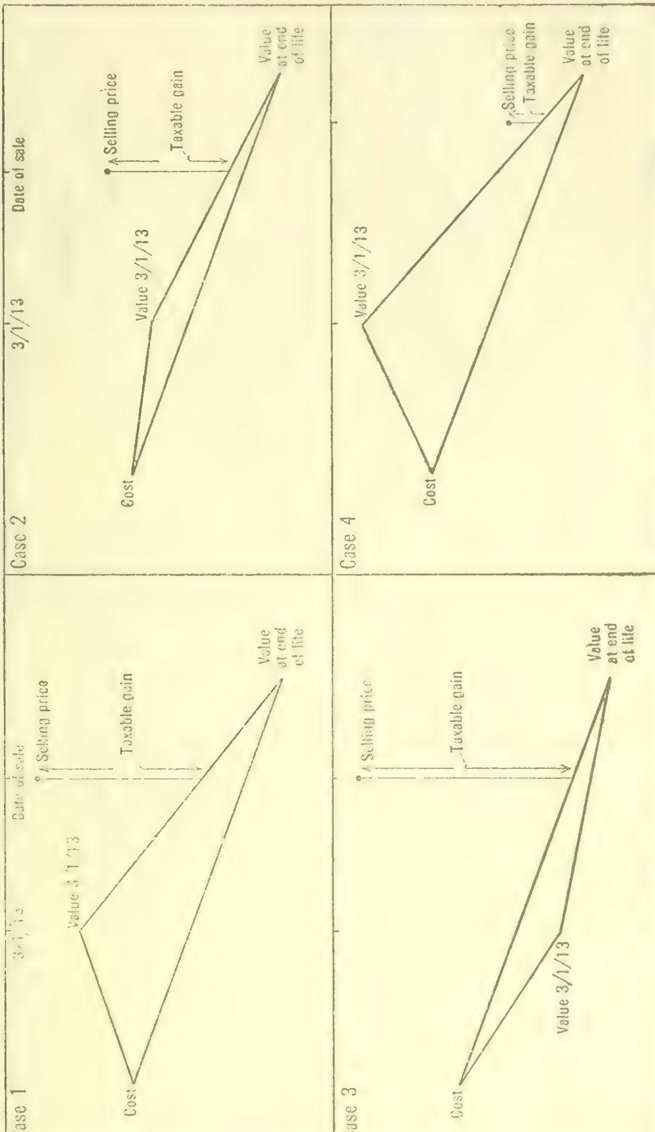
With these two elements to be subtracted from selling price taken into consideration, the general rule laid down in the law, and indicated by the recent decision of the Supreme Court,[13] viz., that there can be no taxable gain unless selling price exceeds cost, is applied. Application of this rule means that there is no taxable gain unless selling price exceeds cost depreciated to date of sale; i.e., there cannot be any gain unless the seller gets more than the value he would be assumed to have if there is taken into account depreciation upon cost to the date of sale.

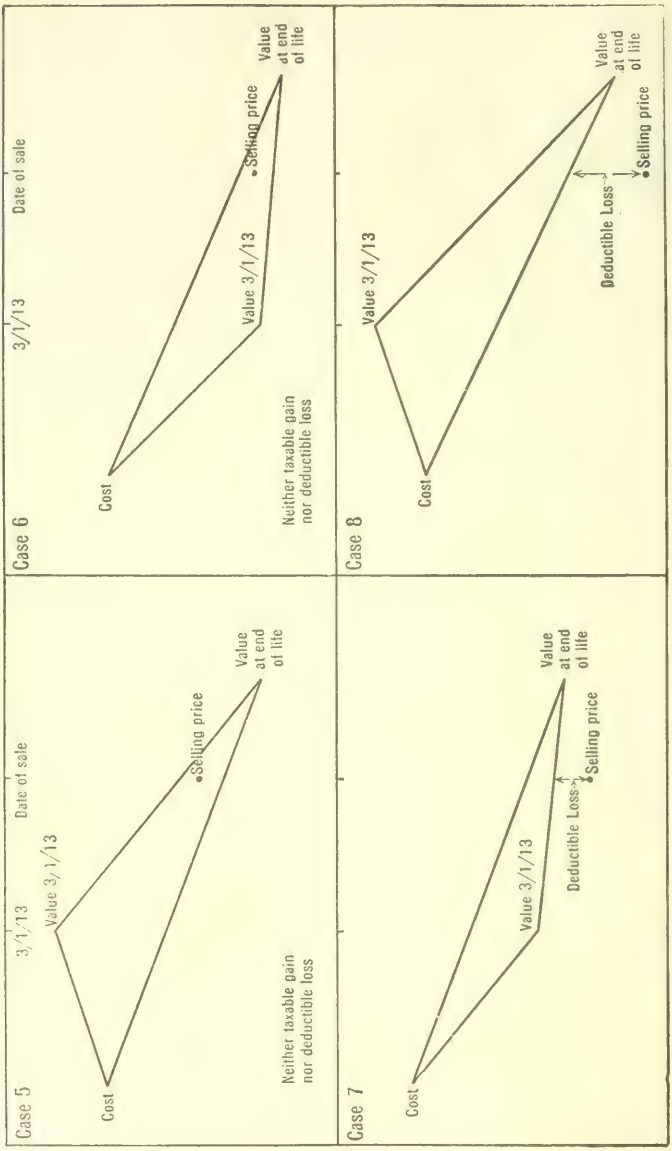
Value at March 1, 1913, depreciated to date of sale, however, offers a check upon the possible gain, in that if the excess of selling price over March 1, 1913 value depreciated to date of sale, is less than the excess of selling price over cost depreciated to date of sale, the taxable gain will be the smaller difference. If value at March 1, 1913, is greater than cost depreciated to March 1, 1913, then, since the normal course of depreciation from value at March 1, 1913, and from cost will bring the value to zero at the same date in both cases, the lines representing the theoretical decline in value due to depreciation with reference to cost and with reference to value at

[13] *Walsh v. Brewster*, U. S. Sup. Ct., March 28, 1921, advance opinions, 65 L. Ed. 451.

March 1, 1913, must always occupy the same relation to each other during the remaining life of the asset after March 1, 1913. Hence, if the line from value at March 1, 1913, to value at the end of the useful life of the property is above the line representing decline in value as measured by depreciation of cost, the inference is proper that some part of the gain represented by the excess of selling price over cost depreciated to date of sale is due to the appreciation that had brought the value at March 1, 1913, above cost depreciated to that date. Consequently, such part of the total gain represented by the excess of selling price over cost must be eliminated from possible taxable gain.

The results as to taxable gains and deductible losses, and as to cases in which there is no taxable gain, are worked out in the following charts:


Case 1
Cost
Value 3/1/13
Date of sale
Selling price
Taxable gain
Value at end of life
Case 2
Cost
3/1/13
Value 3/1/13
Date of sale
Selling price
Taxable gain
Value at end of life
Case 3
Cost
Value 3/1/13
Selling price
Taxable gain
Value at end of life
Case 4
Cost
Value 3/1/13
Selling price
Taxable gain
Value at end of life


Case 5
Cost
3/1/13
Value 3/1/13
Date of sale
Selling price
Value at end of life
Neither taxable gain nor deductible loss
Case 6
Cost
3/1/13
Value 3/1/13
Date of sale
Selling price
Value at end of life
Neither taxable gain nor deductible loss
Case 7
Cost
Value 3/1/13
Deductible Loss
Selling price
Value at end of life
Case 8
Cost
Value 3/1/13
Deductible Loss
Selling price
Value at end of life

(Life of asset, 20 years from 1908)
(Life of asset, 15 years from 1913)

CASE 1

1908 Cost	$10,000	
Less: Depreciation on cost 1908-1921	7,000	$ 3,000
1921 Sales price		$20,000
March, 1913, value	$15,000	
1913-1921 *Less:* Depreciation on March, 1913, value	9,000*	6,000
1921 Net gain		$14,000

*In the illustrations 1913 has been considered as a full year, to make them simpler.

The foregoing shows the advantage of revaluation at March 1, 1913. The net gain based on depreciated cost would be $17,000; i.e., $20,000—($10,000—$7,000).

CASE 2

1908 Cost	$10,000	
Less: Depreciation on cost 1908-1921	7,000	$ 3,000
1921 Sales price		$20,000
March 1, 1913, value	$ 9,000	
Less: Depreciation 1913-1921	5,400	3,600
1921 Taxable gain		$16,400

The foregoing shows the advantage of using March 1, 1913, net value. The original cost is greater than the March 1, 1913, value, but the *depreciated* value at March 1, 1913, is greater than the *depreciated* cost. Therefore the higher figure is used. Had the depreciated cost been used, the net gain would be $17,000; i.e., $20,000—($10,000—$7,000).

CASE 3

March, 1913, value	$ 5,000	
Less: Depreciation 1913-1921	3,000	$ 2,000
1921 Sales price		$20,000
1908 Cost	$10,000	
Less: Depreciation on cost 1908-1921	7,000	3,000
1921 Taxable gain		$17,000

The foregoing shows the advantage of ignoring March 1, 1913, value when it is lower than cost. The net gain, based on

depreciated March 1, 1913, value, would be $18,000; i.e., $20,-000—($5,000—$3,000).

It might be urged that the only depreciation which need be deducted is on cost to February 28, 1913, and on the March 1, 1913, value subsequently.

In case 3 the depreciation to February 28, 1913, on cost is	$ 2,500
Depreciation 1913-1921 on depreciated value	3,000
Total depreciation	$ 5,500
Original cost	10,000
Net cost	$ 4,500
Sales price	20,000
Net gain	$15,500

In the opinion of the author, the foregoing method is not sound. It is true that

The depreciation deduction for income tax purposes is	$ 3,000
Instead of on cost	4,500
An apparent loss of	$ 1,500

The law states that taxpayers may invoke the original cost basis instead of March 1, 1913, value, provided such basis prevents the imposition of the tax on unrealized gains. But there is nothing in the law which states that the privilege of ignoring the March 1, 1913, value may be invoked to reduce an unjust tax and at the same time there may be ignored the inevitable depreciation which is going on. If cost was $10,-000 and the effective life is twenty years, at the end of fourteen years there is a reduction in the capital of $7,000. The taxpayer receives that benefit annually as a return of his capital invested. If he wishes to ignore the March 1, 1913, revaluation in order to reduce his tax from $18,000 to $17,000, he should not also be able to partially use the March 1, 1913, value and reduce the tax from $17,000 to $15,500.

In 1908 there was no federal tax law. From 1909 to 1912 corporations would have been able to deduct depreciation on $10,000. *Individuals would not.* After 1913 individuals and corporations could deduct depreciation on $5,000. There-

fore the factor of the depreciation allowance granted under federal laws can hardly be a factor when the sole question involved is to secure the benefit of a departure from the March 1, 1913, value.

CASE 4

1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
1921 Sales price		$8,000
March 1, 1913, value	$15,000	
Less: Depreciation 1913-1921	9,000	6,000
1921 Taxable gain		$2,000

As in case 1, the foregoing shows the advantage of using March 1, 1913, value even though the sales price is less than the original cost and also less than the value at March 1, 1913. The *depreciated* March 1, 1913, value at date of sale being greater than the *depreciated* cost, the higher figure is used in computing the profit. Had depreciated cost been used the profit would be $5,000; i.e., $8,000—($10,000—$7,000).

The foregoing case is illustrated in a February, 1922, ruling:

RULING. A died intestate before 1913. At the time of his death he owned an unimproved lot located upon the principal street of a city and also carried life insurance. The estate descended equally to the widow and children in fee simple. Before 1913 the heirs used the life insurance money and additional money inherited from A in erecting a building upon the land to be used for business purposes. On March 1, 1913, the land and building were worth $100x$ dollars, and during the year 1920 were sold for $120x$ dollars.

Inquiry is made whether (1) in determining the profit, if any, made on the sale, the land should be valued as of the date of decedent's death, that being the date on which the heirs acquired title by operation of law, or whether the value should be fixed as of March 1, 1913; (2) in view of the fact that the improvement was made by the heirs and paid for with money inherited from A, and money received from life insurance which was nontaxable, the land and improvements should be appraised separately or as an entirety.

Held, that in computing the cost of the building and land in question, they should be treated as an entirety—the cost of the land to be determined by its fair market value at the time of the decedent's death and the cost of the building by its actual cost of construction.

The sum of these figures will represent the cost of the improved real estate, and the difference between the cost so arrived at, less depreciation sustained after March 1, 1913, and the selling price, will represent the gain from the transaction. However, if the fair market value of the improved real estate as of March 1, 1913, was in excess of the value of the land at the date of decedent's death plus the actual cost of construction of the building, then the profit subject to tax will be the difference between the value of the improved real estate as of March 1, 1913, less depreciation thereafter sustained, and the selling price. (I-5-49; I. T. 1178.)

CASE 5

March 1, 1913, value	$15,000	
Less: Depreciation 1913-1921	9,000	$6,000
1921 Sales price		$5,000
1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	3,000
Realization of March, 1913, value, not taxable		$2,000

In the foregoing case there is no gain or loss because sales price lies between depreciated cost and depreciated March 1, 1913, value. In this case the book profit of $2,000 is not taxable. The sales price, $5,000, is more than depreciated cost, $3,000 ($10,000—$7,000); but less than depreciated March 1, 1913, value, $6,000 ($15,000—$9,000).

CASE 6

March 1, 1913, value	$ 4,500	
Less: Depreciation	2,700	$1,800
1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
1921 Sales price		2,500
Loss sustained based on March 1, 1913, value (not deductible)		$ 500

The foregoing is similar to case 5 in that the sales price lies between *depreciated* cost and *depreciated* March 1, 1913, value, hence there is no taxable gain or loss. In case 6 the depreciated cost is higher than the depreciated March 1, 1913, value—the converse of case 5.

CASE 7

1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
March 1, 1913, value	$ 5,000	
Less: Depreciation	3,000	$2,000
1921 Sales price		1,000
Deductible loss		$1,000

The foregoing is the same as case 3, except the selling price is *less than* depreciated cost and less than the depreciated March 1, 1913, value. The *lesser* value is used in computing the loss. If computed on depreciated cost, the loss under 1916, 1917 and 1918 laws would be $2,000; i.e., ($10,000—$7,000)—$1,000.

CASE 8

March 1, 1913, value	$15,000	
Less: Depreciation 1913-1921	9,000	$6,000
1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
1921 Sales price		1,000
Deductible loss		$2,000

The foregoing is the converse of case 7, in that the depreciated cost is *less* than the depreciated March 1, 1913, value. As in case 7, the *lesser* value is used in computing the loss. If computed on depreciated March 1, 1913, value, the loss under 1916, 1917 and 1918 laws would be $5,000; i.e., ($15,000—$9,000)—$1,000.

NO ADJUSTMENT FOR DEPRECIATION WHEN RESIDENCE OF TAXPAYER IS SOLD.—

RULING. A taxpayer occupied as a residence a part of a building he purchased before 1913 and rented the other part. In determining the gain from a sale in accordance with article 1561, the amount representing depreciation to be added to the selling price is that sustained on the part of the property used for rental purposes. No depreciation may be considered with respect to that portion of the property used for residential purposes by the taxpayer. (B. Digest 37-21-1810; O. D. 1026.)

The foregoing ruling works out in favor of taxpayers who sell their residences. The deduction of depreciation decreases the book value of the asset and correspondingly increases the gain.

Application of "tax-free" distributions.—If distributions have been received from earnings accumulated prior to March 1, 1913, or from appreciation at that date, the basis prescribed by section 202, as set forth in this chapter, must be reduced by such "tax-free" distribution in case of loss.[14] In case of gain, however, the "tax-free" distributions are ignored.[15]

Surplus arising from reappraisals is not taxable income.—Increased valuations arising from the writing up of book values are not subject to income or excess profits taxes, unless the taxpayer has adopted the inventory method as prescribed by sections 202 (a-1)[16] and 203. In certain cases it is customary and desirable for dealers in securities and similar property to inventory their assets annually. When securities, etc., are stock-in-trade, the best accounting practice requires inventories. But it is not good accounting practice to consider that revaluations of capital assets are equivalent to inventories. This is demonstrated by the practice of accountants who refuse to credit the surplus arising from revaluations of capital assets to the current income or earnings account.

Revaluations as of March 1, 1913, should, however, be used as bases for depreciation and depletion charges, and this requires that the appraisals be entered in the books. Property accounts will be debited and "surplus arising from reappraisement of property" will be credited. The latter account is equivalent to a capital surplus account, excepting that part of the appreciation which may subsequently be realized and

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[14] Section 201 (b).
[15] For full discussion, see Chapter XXIX.
[16] See page 457.

which should then be transferred to an account which on a balance sheet and for excess profits tax purposes would be called "earned surplus." In order to avoid its inclusion as income for the taxable year, the amount on the books should be credited to "surplus earned prior to March 1, 1913."

Written-up book values as of effective date of law never taxable.—The courts have consistently held that, under both the 1909 and the 1913 laws, increases in the value of property, to be subject to the tax, must have occurred during the period when the law was effective. The 1916, 1917, 1918 and 1921 laws, it will be recalled, specifically designate March 1, 1913, as the date from which appreciation, which is taxable when realized, shall be measured.

Supreme Court decisions regarding taxation of appreciation in property values.—We now have a satisfactory line of decisions of the Supreme Court bearing on the question of the taxation of increases in property values, and the fixing of March 1, 1913, as the date for the revaluation of all property, tangible and intangible, for income tax purposes.

CASES UNDER THE 1909 LAW.—The case of *Doyle v. Mitchell Brothers Company*,[17] decided by the Supreme Court of the United States, May 20, 1918, turns upon the question of the taxability of the increased value of certain timber lands:

DECISION. Plaintiff acquired certain timber lands at its organization in 1903, and paid for them at a valuation approximately equivalent to $20 per acre. Owing to increases in the market price of stumpage the market value of the timber land, on December 31, 1908, had become approximately $40 per acre. The company made no entry upon its books representing this increase, but each year entered as a profit the difference between the original cost of the timber cut and the sums received for the manufactured product, less the cost of manufacture. After the passage of the excise tax act,

[17] 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054. See also *U. S. v. Guggenheim Exploration Co.*, 238 Fed. 231; also *Baldwin Locomotive Works v. McCoach* (U. S. Circuit Court of Appeals for the Third Circuit), 221 Fed. 59, 136 C. C. A. 660.

and preparatory to making a return of income for the year 1909, the company revalued its timber stumpage as of December 31, 1908, at approximately $40 per acre. The good faith and accuracy of this valuation are not in question, but the figures representing it never were entered in the corporate books.

The Commissioner declined to recognize the deduction on the basis of the valuation of December 31, 1908. The court refused to sustain the Treasury, its position being shown by the following quotations from the decision:

DECISION. When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and a subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act was in force. Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which, in the present case, are not in dispute.

Occasionally reference is made to appreciation arising from revaluations of corporate assets as of January 1, 1909. It should be noted that revaluations as of that date are of interest only when there was a realization of such appreciation prior to February 28, 1913.[18] The court also said:

Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of "income," it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. . . . .
Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the "gross income" received "from all sources;" and by applying to this the authorized deductions we arrive at "net income." In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must with-

draw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

The same points are reiterated in *Hays v. Gauley Mountain Coal Company*,[18] decided by the Supreme Court on the same day.

DECISION. The expression "income *received during* said year," employed in the act of 1909, looks to the time of realization rather than to the period of accrument, except as the taking effect of the act on a specified date (January 1, 1909) excludes income that accrued before that date. . . . .

As we construe the latter act, it measured the tax by the income received within the year for which the assessment was levied, whether it accrued within that year or in some preceding year while the act was in effect; but it excluded all income that accrued prior to January 1, 1909, although afterwards received while the act was in effect.[19]

CASE UNDER 1913 LAW.—The principle enunciated in the cases arising under the 1909 law was extended to the 1913 law in the case of *Lynch v. Turrish*,[20] decided by the Supreme Court of the United States, June 3, 1918. In this case the plaintiff received in cash double the par value of stock held by him in a lumber company, the distribution being made upon the surrender of the stock, after which the company went out of business. The sum thus distributed represented an "increase due to the gradual rise in the market value of the lands" owned by the company before March 1, 1913. The following are the most pertinent paragraphs of the decision:

DECISION. And in determining the application of the statute to Turrish we must keep in mind that, on the admitted facts, the distribution received by him from the Payette Company manifestly was a single and final dividend in liquidation of the entire assets and business of the company, a return to him of the value of his stock

[18] 247 U. S. 189, 38 S. Ct. 470, 62 L. Ed. 1061.

[19] Again in the case of *U. S. v. C. C. C. & St. L. Railway Co.* (247 U. S. 195, 38 S. Ct. 472, 62 L. Ed. 1064, decided May 20, 1918) the Supreme Court declared: "We concur in the view that the defendant was not taxable except with respect to so much of the profit upon the stock as accrued after December 31, 1908."

[20] 247 U. S. 221, 38 S. Ct. 537, 62 L. Ed. 1087.

upon the surrender of his entire interest in the company, and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect.

The district court and the circuit court of appeals decided[21] that the amount so distributed to Turrish was not income within the meaning of the statute, basing the decision on two propositions, as expressed in the opinion of the circuit court of appeals, by Sanborn, Circuit Judge:—(a) The amount was the realization of an investment made some years before, representing its gradual increase during those years, and which reached its height before the effective date of the law, that is, before March 1, 1913, and the mere change of form of the property "as from real to personal property, or from stock to cash," was not income to its holders because the value of the property was the same after as before the change; (b) The timber lands were the property, capital, and capital assets of their legal and equitable owner, and the enhancement of their value during a series of years "prior to the effective date of the income tax law, although divided or distributed by dividend or otherwise subsequent to that date, does not become income, gains, or profits taxable under such an act." . . . .

If increase in value of the lands was income, it had its particular time, and such time must have been within the time of the law to be subject to the law; that is, it must have been after March 1, 1913. But, according to the fact admitted, there was no increase after that date, and therefore no increase subject to the law. There was continuity of value, not gain or increase. In the first proposition of the court of appeals we, therefore, concur.

After considering the contentions of the government in the case of *Gray v. Darlington* (15 Wall. 63, 82 U. S. 63, 21 L. Ed. 45), the court indicated its concurrence with the second proposition of the Circuit Court of Appeals as well.[22]

[21] 236 Fed. 653.

[22] In a series of decisions the Supreme Court has interpreted the law as it affects the taxability of dividends received when such dividends represent in part surplus accumulated or assets increased in value before March 1, 1913. This matter is fully discussed in Chapter XXII, "Income from Dividends." It should be pointed out here, however, that the court has established a distinction depending upon the nature of the transaction. Dividends from such funds were declared not taxable in the *Turrish* case, discussed above, where there was a single final dividend; in the case of *Southern Pacific Co. v. Lowe* (247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142, June 3, 1918), where the dividend was a mere paper transaction the holding company itself doing the business of the subsidiary and having possession of the property; and in the case of the *Gulf Oil Corporation v. Lewellyn* (248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133, December 9, 1918) where the holding company owned all the shares in the subsidiary except the directors' qualifying shares. In the case of *Lynch v. Hornby*

Basis when shares of same issue are bought and sold at different dates.—Securities owned by a dealer may be inventoried[23] and profits may be ascertained on the basis of the valuations thus determined. Other securities are to be valued in accordance with the following procedure:

REGULATION. When shares of stock in a corporation are sold from lots purchased at different dates and at different prices and the identity of the lots can not be determined the stock sold shall be charged against the earliest purchases of such stock. The excess of the amount realized on the sale over the cost of the stock will constitute gain. However, the gain to be included in gross income in the case where the stock was acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, is the excess of the amount realized by the sale over such value. No gain is recognized when stock is sold at more than its cost but at less than its fair market value as of March 1, 1913. In the case of stock in respect of which any stock dividend was paid, the cost of each share of such stock shall be ascertained as specified in article 1548. . . . . (Art. 39.)

The theory of this regulation is wrong. When different purchases of the same issue of stock are made the actual result is an average cost. When a taxpayer buys 100 shares of a stock at 80 and later buys 100 shares at 60, he owns 200 shares at 70 and any subsequent accounting should be based

(247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, June 3, 1918) a sharp distinction is drawn between the type of dividend discussed in the foregoing decisions and the case of the "ordinary stockholder receiving dividends declared in the ordinary course of business." The court declared that "under the 1913 act dividends declared and paid in the ordinary course by a corporation to its stockholders, after March 1, 1913, whether from current earnings or from a surplus accumulated prior to that date, were taxable as income to the stockholder." The case of *Peabody v. Eisner* (247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, June 3, 1918), (also brought under the 1913 law) was declared to be controlled by *Lynch v. Hornby, supra.* The same rule was applied in *Union Pacific Coal Co. v. Skinner,* 249 Fed. 152, 161 C. C. A. 204; affirmed, 252 U. S. 570, 40 S. Ct. 392, 64 L. Ed. 721.

It can hardly be said, therefore, that the Supreme Court has decided that all values existing at March 1, 1913, are capital, but the 1916, 1917 and 1918 revenue laws are quite definite on the point that dividends declared out of surplus accrued prior to March 1, 1913, are not taxable, so that the case of *Lynch v. Hornby, supra,* has no bearing on dividends received after January 1, 1916.

[23] See page 485. Banks and financial institutions are required to account for profits on securities in the same fashion as individuals, except where the bank maintains a branch or department for dealing in securities.

on the average. There are difficulties in the application of the average rule when the certificates for the shares can be identified because there may be an actual intention on the part of the taxpayer to separate the transactions. Even here the right to select the certificates to be sold is used by some taxpayers to evade the intention of the law even though they follow the regulations.

Inventory method not applicable.—The measurement of gain in the case of property subject to inventory has been adequately discussed in the preceding chapter.[24] As to other property, the law plainly designates cost as the base from which to measure appreciation in the case of property acquired on or after March 1, 1913, and the value on that date for property acquired prior thereto, with the exceptions previously noted.

Section 203 of the law grants to the Commissioner full authority to require taxpayers to inventory their assets, so long as the basis prescribed conforms "to the best accounting practice in the trade or business" and "as most clearly reflecting the income." It would seem that there is a very definite limitation upon the power of the Commissioner because it is not customary in any trade or business to inventory annually or periodically the capital assets. The inventory method is used only with trading assets. Although it might be highly desirable, no specific authority is given to prescribe inventories for those not engaged in trade or business.

Basis for Ascertaining Gain or Loss When Property Disposed of Was Received in a Continuing Transaction

In the preceding chapter the determination of whether a transaction is closed or continuing has been treated.[25]

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[24] See page 457 *et seq.*

[25] For full discussion of transactions deemed not to be "closed," see Chapter XVI.

When the transaction is deemed to be continuing, the 1921 law specifies how the basis for computing profit on subsequent resale is to be ascertained, as follows:[26]

1. The general rule is that the cost or March 1, 1913, value of the old property exchanged is assigned to the new property received [section 202 (d-1)].
2. Property "replaced" is assigned a proportionate part of the cost of the old property destroyed in the ratio of amount expended to amount recovered [section 202 (d-2)].[27]
3. In the case of "wash sales" the cost or March 1, 1913, value of the securities sold, or a *pro rata* part where only a part of the transaction is deemed to be a "wash sale," is assigned to the securities purchased [section 202 (d-3)].[28]
4. When part cash and part property having no readily realizable market value are received, the amount of cash serves to reduce the original cost or March 1, 1913, value of the old property exchanged [section 202 (e)], except that
5. When property of the following class is received even though it may have a readily realizable market value, viz.,
   (a) Property of a like kind or use.
   (b) Securities received in a "reorganization."
   (c) Securities received from an 80 per cent controlled corporation.
   (d) Cash or property (other than mentioned under (a), (b) and (c)) having a readily realizable market value.

Only the items in (d) serve to reduce the basis of the original cost or March 1, 1913, value.

[26] Section 202 (d) and 202 (e).
[27] For discussion and illustration see Chapter XV, and page 591.
[28] The deductibility of losses on "wash sales" is discussed in Chapter XXIX, and at page 591.

Property received takes the place of the property exchanged.—

LAW. Section 202. . . . . **(d) (1) Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e); . . . .**

No problem arises when a transaction is deemed not to be closed except that taxpayers who exchange property for other property sometimes neglect to preserve the records which show the original cost. These records are particularly valuable when losses are claimed. Revenue agents are justified in demanding trustworthy records.

REGULATION. (*a*) Where property is exchanged for other property and no gain or loss is recognized under articles 1564 or 1566 the property received shall for the purpose of determining gain or loss from its subsequent sale be treated as taking the place of the property exchanged therefor. . . . . For exchange of property acquired prior to March 1, 1913, see article 1561. If property is exchanged for two kinds of property and no gain or loss is recognized under articles 1564 or 1566 the cost of the original property should be apportioned, if possible, between the two kinds of property received in exchange for the purpose of determining gain or loss upon subsequent sale. If no fair apportionment is practicable, no profit on any subsequent sale of any part of the property received in exchange is realized until out of the proceeds of sale shall have been recovered the entire cost of the original property. When securities of a single class are exchanged for new securities of different classes so that no gain or loss is realized under the provisions of paragraph (*b*) of article 1566, for the purpose of determining gain or loss on the subsequent sale of any of the new securities the proportion of the original cost, or other basis, to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. For example, if 100 shares of common stock, par value $100, are exchanged for 50 shares of preferred and 50 shares of common each of $100 par value, and the cost of the old stock was $250 per share, or $25,000, but the market value of the preferred on the date of the exchange was $110 per share, or $5,500 for the 50 shares, and the market value of the common was $440 per share or $22,000 for the 50 shares of common, one-fifth of the original cost, or $5,000, would be regarded as the cost of the preferred and

four-fifths, or $20,000 as the cost of common. The same method of computation should be used in the case of stock acquired prior to March 1, 1913, in order to ascertain the proportion of such value to be allocated to each class of new securities on that date and the taxable gain or deductible loss should thereafter be computed in accordance with article 1561. . . . . (Art. 1567.)

Basis when "replacement funds" are established and property lost or destroyed is replaced.—

REGULATION. . . . . (*b*) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in sections 214 (a) (12) and 234 (a) (14) and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall for the purpose of determining gain or loss from its subsequent sale be treated as taking the place of a like proportion of the property converted. (Art. 1567.)

Full discussion of "replacement funds" and the treatment of property replaced thereunder, with an illustration of the manner in which the deferment of profit thereon serves to reduce the basis of cost proportionately, will be found in Chapter XV.

Basis when loss on "wash sales" is denied.—

LAW. Section 202. . . . . **(d) . . . . (3) Where no deduction is allowed for a loss or a part thereof under the provisions of paragraph (5) of subdivision (a) of section 214 and paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of. . . . .**

Assume that securities costing in 1915 $100,000, were sold in 1922 for $60,000, registering a loss of $40,000. If $20,000 of this loss were disallowed as arising from a "wash sale" (due, for instance, to a partial repurchase), then the "cost" of one-half of the securities repurchased would be deemed to be one-half of the cost of the securities disposed of, viz., $50,000.

For discussion of losses on "wash sales" and similar transactions, see Chapter XXIX, "Deductions for Losses."

Effect of the receipt of cash (or property other than cash) by former owners.—The following section gives effect to the new provisions of the 1921 law holding certain transactions not to be closed, but for purpose of computing profit on a subsequent sale certain adjustments of the original cost or March 1, 1913, value have to be made.

LAW. Section 202. . . . . (e) Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivisions (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess. . . . .

The rule laid down in the foregoing section of the law may be stated as follows: When the transaction is not closed, the cash or other property having a readily realizable market value (other than the three exceptions stated) received in exchange is regarded as a return (in whole or in part, as the case may be) of the taxpayer's investment.

The following illustrations show the two applications of the rule, when the transaction is regarded as a continuing one.

CASE I

Land costing in 1915 $25,000	is exchanged in 1921 for	Securities (having no readily realizable market value) Cash $10,000

In the above case the securities are regarded as taking the place of the land, but the cash received $10,000 is applied against the $25,000, so that the "cost" of the securities, upon resale, is deemed to be $15,000.

Case II

Land costing in 1915 $25,000	is exchanged in 1921 for	(a) Land [29] or (b) Securities in an 80 per cent controlled corporation [30] or (c) Either one or both of the above two classes, all having a readily realizable market value; and (d) Cash, or securities of a kind different from those in (b) or (c) above, having a readily realizable market value of $10,000

In the second case, while any or all of the two specific classes of property (a) and (b) above may have a readily realizable market value, the receipt thereof is, under section 202 (c), deemed to be a continuing transaction in which neither gain nor loss is recognized. Therefore, only the value of property (d) in the illustration above, $10,000, is regarded as a return on account of the original investment of $25,000, and thus serves to reduce the basis to $15,000 for purpose of computing profit on any subsequent sale of property (a) or (b).

If, in the foregoing illustration, property (d) had an aggregate value of $30,000 instead of only $10,000, a profit of $5,000 would have to be reported for the period during which the transaction occurred, and upon the sale of any of the property (c) or (b) the full amount realized would have to be reported as taxable income.

Case III

Stocks and bonds in company costing in 1915 $25,000	are exchanged in 1921 for	Securities in B Company, in a "reorganization" [31] of A Company, having a readily realizable market value; and Cash $10,000

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[29] For discussion of property of a "like kind or use" [section 202 (c-1)], see page 545.

[30] Transfers of property to a corporation in which the transferors control 80 per cent or more of the stock [section 202 (c-3)] is discussed at page 560.

[31] "Reorganizations" [section 202 (c-2)] are treated at page 557.

The third case above is also deemed to be a continuing transaction, under section 202 (c), although the securities received in the "reorganization" have a readily realizable market value at the time of their receipt by the taxpayer. The amount of cash ($10,000), however, reduces the basis of the original securities, so that upon subsequent sale of the new securities their "cost" is deemed to be $15,000.

Official illustrations.—The official illustrations, together with a tabular statement thereof so that they may be readily followed, are given below:

Regulation. . . . . *Examples.*—(1) A exchanged certain property which he had purchased subsequent to March 1, 1913, for $5,000, for real estate having no readily realizable market value and $2,000 in cash. No gain or loss is realized from such exchange. However, if A subsequently sells the real estate, the difference between the amount realized therefor and $3,000, the basis of the property exchanged reduced by the amount of cash received in the exchange, is taxable gain or deductible loss, as the case may be. . . . . (Art. 1568.)

(1) Property, cost (after March 1, 1913) $5,000	is exchanged for	Real estate having no readily realizable market value Cash $2,000

Basis—"cost" of real estate received is $3,000, viz., $5,000—$2,000.

Regulation. . . . . (2) A exchanged certain property which he had purchased subsequent to March 1, 1913, for $14,000, for stock having no readily realizable market value and bonds having a readily realizable market value of $16,000. A realized a taxable gain of $2,000, the amount by which the fair market value of the bonds exceeds the cost of the property exchanged. The entire amount received from the subsequent sale of the stock received in the exchange constitutes taxable income. . . . . (Art. 1568.)

(2) Property, cost (after March 1, 1913) $14,000	is exchanged for	Stock (having no readily realizable market value) Bonds (market value $16,000)

Taxable gain $2,000, viz., $16,000—$14,000.
Basis—"cost" new of stock received is 0.

Regulation. . . . . (3) A, in connection with a reorganization of a corporation, received in place of stock purchased by him subsequent to March 1, 1913, for $9,000, stock in a corporation a

party to the reorganization together with cash in the amount of $4,000. No gain or loss is realized from the exchange. However, if A subsequently sells the stock, the difference between the amount received therefor and $5,000, the basis of the old stock reduced by the amount of cash received in the exchange, constitutes taxable gain or deductible loss, as the case may be. . . . . (Art. 1568.)

(3) Stock, cost (after March 1, 1913) $9,000	is exchanged for	Stock in a "reorganization" Cash $4,000

Basis—"cost" of stock received is $5,000, viz., $9,000—$4,000.

REGULATION. . . . . (4) A transferred to a corporation, all of the outstanding stock of which was owned by him, property purchased by him subsequent to March 1, 1913, for $40,000, in exchange for stock and $50,000 in cash. A realized from the exchange a taxable gain of $10,000, the amount by which the amount of the cash exceeds the cost of the property transferred. The entire amount received from the subsequent sale of the stock received in the exchange constitutes taxable income. . . . . (Art. 1568.)

(4) Property, cost (after March 1, 1913) $40,000	is exchanged for	Stock (in a totally owned corporation) at least 80 per cent controlled Cash $50,000

Gain $10,000, viz., $50,000—$40,000.
Basis—new "cost" of stock received is 0.

REGULATION. . . . . It is assumed in the above examples that the property exchanged was not of a kind properly to be included in inventory. If the property exchanged was acquired prior to March 1, 1913, or by gift, devise, bequest, or inheritance, see articles 1561, 1562, and 1563. . . . . (Art. 1568.)

The basis to be used in case of property acquired prior to March 1, 1913, is discussed at page 569.

Property acquired by gift after December 31, 1920, is deemed to have, in the hands of the donee, the same cost or March 1, 1913, value as if still in the possession of the donor.[32] Gifts acquired prior to December 31, 1920, and property acquired by devise, bequest or inheritance are treated at pages 620.

[32] See page 619.

Determination of Fair Market Price or Value at March 1, 1913

It should be noted that the law does not require the determination of "fair market value" on March 1, 1913, but "fair market price or value." If fair market price can be ascertained, nothing further is needed. But it must be "fair," that is, representative and not narrow.

The sale of a few shares of stock out of thousands is not a fair criterion. In addition the price must meet the common definition of "market," which presumes a willing buyer and a willing seller.

If any one of these elements is lacking we use the alternative provided in the law, viz., "value." Often the Treasury fails to consider the second standard and insists on the first.

No specified method of determining values.—

REGULATION. . . . . What the fair market value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear. . . . . (Art. 1561.)

Realizations may not occur for many years and it is sometimes difficult because of the lapse of time to determine a fair value as of March 1, 1913.[33] It is advisable, therefore, if sales are at all probable, to give consideration to the factors underlying valuations and to accumulate evidence to establish true values as of that date.

The cost of reproduction is rarely a satisfactory basis for the determination of fair market value as of any date. When applied to the present time we find that many properties are sold for less than it would cost, at present prices, to reproduce them. In many cases during the war, prices were paid far in excess of reproduction costs. Recent sales by willing sellers to willing buyers are the best bases of all, but the records of such sales are confined almost entirely to stock and similar

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[33] For definitions of "value," see *Income Tax Procedure,* 1920, pages 343-344.

exchanges. Reproduction cost may, however, be very useful evidence in establishing fair market value.

What is "fair market value"?—The following extract from a charge to a jury which was approved[34] on appeal by the United States Supreme Court may be used as an authoritative guide in determining what is "fair market value."

DECISION. The market value of goods is the price at which the owner of the goods, or the producer, holds them for sale; the price at which they are freely offered in the market to all the world; such prices as dealers in the goods are willing to receive, and purchasers are made to pay, when the goods are bought and sold in the ordinary course of trade. . . . . The defendant asserts . . . . that the only way to arrive at the market value is to take the cost of production, to compute how much the manufacturer has actually disbursed in producing the goods, and that thus you have the actual market value. The United States, however, maintain that . . . . they are freely offered to all the world, and held at known and established rates; . . . . and at which they are ready to furnish them to all the world. If this latter state of facts be true, then it is evident that the prices at which the producers so hold them are the market prices. . . . .

The Treasury's definition of "fair market value" is set forth in a ruling quoted in full on page 539.

WHAT IS "VALUE" MARCH 1, 1913?—In the absence of trustworthy data regarding "fair market price," the law gives taxpayers the alternative of determining the value of property on March 1, 1913. The courts and text writers have frequently differentiated between the two terms and little difficulty is encountered in ascertaining the general principles to be observed.

In the case of *Virginia v. West Virginia*,[35] decided June 14, 1915, by the United States Supreme Court, wherein the issue was to determine what proportion of Virginia's indebtedness the new state of West Virginia should pay, it became necessary to make adjustments of certain credits and debits as of January 1, 1861, arising out of the valuation of certain rail-

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[34] *Cliquot, Champagne*, 3 Wall. 114, 70 U. S. 114, 18 L. Ed. 116.
[35] 238 U. S. 202, 59 L. Ed. 1272, 35 S. Ct. 795.

way stocks and other securities as of that time. Justice Charles E. Hughes, in speaking of stock of Richmond, Fredericksburg and Potomac Railroad Company (one lot amongst the several involved), said:

DECISIONS. The fact, however, that there was no sufficient proof of market value was not an insuperable obstacle to the making of a fair valuation. It was clearly proper to introduce evidence tending to show the intrinsic value of the shares. . . . . (*Nelson* v. *First National Bank*, 69 Fed. 798-803; *Critchfield* v. *Julia*, 147 Fed. 65, 73; *Henry* v. *N. A. Construction Co.*, 158 Fed. 79, 81; *Murray* v. *Stanton*, 99 Mass. 345; *Industrial and General Trust Co.* v. *Tod*, 180 N. Y. 215, 232; *State* v. *Carpenter*, 51 Oh. St. 83; *Redding* v. *Godwin*, 44. Minn. 355; *Moffitt* v. *Hereford*, 132 Mo. 513.)

Property concerning which no proof of value in the market can be given, because it is not brought into the course of trade and is incapable of any estimate in that mode is often the subject of legal valuation. In such cases the value is to be ascertained from such elements of value as the property represents, among which may be the cost of producing an article. . . . . The question of value is not to be determined by considering the separate elements of which the property is composed, but by taking it as a whole, where it is, regard being had for the purpose for which it was intended and for which it is to be used.[36]

Where property is destroyed and injured which has a market value, this must be shown as the measure of damages; where it has no market value and a real value is shown, this is the measure of plaintiff's recovery; where it has neither a market value nor a real value, but it is shown what it would cost to replace or reproduce the article, then such costs is the measure of damages. But if the article has no market value nor real value, and it cannot be reproduced or replaced, then in that event it would be proper to show what it was worth to the plaintiff. . . . .[37]

. . . . Yet a thing not bought and sold in the market may have a value, as when it is an article fitted for a specific use of the owners, and worthless for every other purpose. To attempt to test it by the open market, where it is never offered for sale, and is never bought, would be absurd. In reason the cost of replacing it would ordinarily be the standard of its value.[38]

Ordinarily, when an article of sale is in the market, and has a

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[36] Sutherland on Damages, Volume 2, Article 448, Fourth Edition.

[37] *M. K. & T. Ry. Co. v. Crews*, 120 S. W. 1110, 54 Tex. Civ. App. 612.

[38] *Martinez v. State*, 16 Tex. App. 122, quoting *2 Bish. Crim. Prac.*, sec. 751.

market value, there is no difference between its value and the market price, and the law adopts the latter as the proper evidence of its value. This is not, however, because value and price are really convertible terms, but only because they are ordinarily so in a fair market. The primary meaning of value is worth, and this worth is made up of the useful or estimable qualities of the thing. . . . .[39]

The "value" of land sought to be condemned, which the petitioner is required to pay, is not what any one person would give for the land for his own particular use, but what could probably be obtained for it if a sale was desirable and a purchaser sought, applying the ordinary business methods to find him and to dispose of the property.[40]

Valuation of patents.—The valuation of patents as at March 1, 1913, is fully discussed in Chapter XVIII.

Value of mines, oil wells, etc., March 1, 1913.[41]—The general principles underlying valuations as of a past date have been stated. In valuing mines, oil wells and other natural resources the Treasury requires many details. The burden of proof is properly put upon taxpayers to support their claims and any reasonable data required must be furnished or taxpayers may expect that claims will be disallowed. As the Treasury's requirements[42] are available to all who are interested it is not necessary to quote at length therefrom.

COMPUTATION OF VALUE OF MINES, ETC., AT MARCH 1, 1913, OR ANY OTHER GIVEN DATE.—The following table is used

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[39] *Kountz v. Kirkpatrick*, 72 Pa. St. 376, 13 Am. Rep. 687.

[40] *Weiser Valley Land & Water Co. v. Ryan*, 190 Fed. 417, 111 C. C. A. 221, (the quotation is from the syllabus to the case).

[41] For detailed regulations describing the present value method, see Chapter XXXIII.

[42] The following forms may be obtained upon application to the Superintendent of Documents, Government Printing Office, Washington, D. C., for a nominal sum:

Form D Schedules for valuation, depletion and depreciation
E Schedule for valuation of coal properties
F Schedule for valuation of deposits of non-metals
O For oil and gas producers
T General forest industries questionnaire for the years prior to 1919
T (Timber) Forest industries schedule

by the Treasury's engineers in the valuation of mines, in those cases in which the valuation is based on the discounting of prospective earnings to present value. Following the table is an illustration showing the application of the formula.

Present Worth of Each Dollar of Operating Profit

Accumulated during life of n years, assuming annual rate of production and operating profits per unit to be uniform and providing for interest on present worth at r' per cent annually and a payment into a sinking fund which at 4 per cent, interest compounded annually, will amount to the present worth, i.e., provide for return of capital, at the end of life.

Yrs.	6%	7%	8%	9%	10%	12%	15%
1	.943396	.934579	.925925	.917431	.909091	.892857	.869565
2	.908766	.892946	.876891	.861777	.847176	.819408	.781010
3	.876389	.853937	.832607	.812317	.792993	.756976	.708694
4	.846052	.818370	.792418	.768072	.745178	.703254	.648525
5	.817570	.785469	.755780	.728260	.702675	.656540	.597680
6	.790781	.754961	.722245	.692177	.664641	.615547	.554148
7	.765540	.726638	.691435	.659519	.630410	.579284	.516457
8	.741717	.700174	.663032	.629635	.599440	.546979	.483507
9	.719198	.675487	.636765	.602251	.571286	.518017	.454455
10	.697880	.652354	.612404	.577066	.545581	.491906	.428649
11	.677672	.630699	.589748	.553820	.522019	.468244	.405574
12	.658489	.610277	.568624	.532281	.500344	.446702	.384818
13	.640258	.591066	.548887	.512330	.480337	.427009	.366049
14	.622911	.572950	.530401	.493737	.461815	.408936	.348995
15	.606385	.555828	.513053	.476390	.444619	.392292	.333431
16	.590625	.539630	.496741	.460167	.428610	.376914	.319170
17	.575581	.524283	.481376	.444963	.413671	.362663	.306056
18	.561205	.509716	.466880	.430685	.399699	.349420	.293955
19	.547455	.496371	.453178	.417253	.386603	.337082	.282754
20	.534292	.482719	.440211	.404592	.374302	.325559	.272358
21	.521680	.470171	.427920	.392637	.362729	.314774	.262682
22	.509587	.458216	.416255	.381334	.351818	.304658	.253654
23	.497979	.446805	.405166	.370630	.341517		
24	.486835	.435903	.394619	.360479	.331775		
25	.476122	.425477	.384571	.350840	.322549		
26	.465820	.415496	.374988	.341675	.313799		
27	.455905	.405935	.365839	.332951	.305488		
28	.446356	.396767	.357096	.324637	.297587		
29	.437155	.387970	.348734	.316704	.290063		
30	.428283	.379520	.340726	.309127	.282893		
31	.419724	.371390	.333054				
32	.411462	.363589	.325695				
33	.403483	.356072	.318631				
34	.395772	.348832	.311846				
35	.388318	.341856	.305324				
36	.381108	.335128	.299049				
37	.374130	.328637	.293009				
38	.367375	.322371	.287190				
39	.360832	.316318	.281581				
40	.354491	.310468	.276171				
41	.348345	.304811	.270950				
42	.342385	.299339	.265909				
43	.336602	.294043	.261038				
44	.330990	.288913	.256328				
45	.325540	.283945	.251774				
46	.320248	.279128	.247367				
47	.315107	.274459	.243100				
48	.310109	.269929	.238967				
49	.305250	.265533	.234962				
50	.300525	.261266	.231079				

Factors in Above Table

$$\frac{P_n}{n} = \frac{1}{\dfrac{n}{R^n - 1} + nr'}$$

Derived from Hoskold's Formula

Present value of $1 per annum in n years, interest on capital being at one rate, r', and for redemption another rate, r, per cent. $\Big\} = P_n$

$$P_n = \frac{1}{\dfrac{r}{R^n - 1} + r'} \quad \text{where } R^n = (1 + r)^n$$

EXAMPLE

Copy of a memorandum prepared by the Metals Valuation Section of the Income Tax Bureau in determining the valuation of mine at March 1, 1913. Italics are author's notes.

Ore reserves March 1, 1913 .... 875,000 tons

Gross value March 1, 1913 (875,000 × $12.78) $11,182,500
Selling price of metal in ore reserves—actual or anticipated.
Gross cost March 1, 1913 (875,000 × $7.1537) 6,259,487
Cost of mining and extracting metal in ore reserves—actual or anticipated and exclusive of depletion and of depreciation of plant.
Art. 206 of Reg. 62, defines such "cost" as comprising all current expenses of producing, preparing and marketing the mineral product sold, exclusive of federal income and profits taxes, allowable capital additions as defined in Art. 222 of Reg. 62, and deductions for depreciation and depletion, but including cost of rapairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency.

Net returns (*actual or anticipated*) $4,923,013

Present worth (discounting at 15% and 4%, using 8-year life).
Present worth is inclusive of cost of plant and is based on earnings on capital or purchase price at the rate of 15% per annum and making payments into a sinking fund which at 4% compounded annually will provide for the return of capital at end of 8-year life.
The above table is calculated for the investment of a sinking fund at 4%, the variables being the rate of discount on capital and the years of life. From the table we find that the present value of each dollar of operating profit accumulated during the life is .48350694.

Present worth therefore is $4,923,013 × .483507 = $2,380,311
Deduct cost of plant (*actual or prospective*) 1,000,000

The Treasury deducts the full cost (actual or prospective) of the plant from the March 1, 1913, present value of the mine on the assumption that the plant must be constructed and the full investment therefor made at the beginning of the period during which the ore is to be removed. If the plant had been constructed prior to March 1, 1913, its value at that date would be deducted.

Market value of ore *en bloc* March 1, 1913 .... $1,380,311

Unit of depletion per ton ($1,380,311 ÷ 875,000 tons) $1.5775

"DISCOVERY" VALUE OF MINES, OIL AND GAS WELLS.—

RULING. In computing the gain or loss from the sale of mines, oil and gas wells, discovered on or after March 1, 1913, the tax-

payer is not entitled to set up the value as of date of the discovery or within thirty days thereafter, as the basis of the computation. . . . . (C. B. 3, page 44; Sol. Op. 26.)

Such value is permitted, however, for depletion purposes. (See Chapter XXXIII.)

Value of claims for infringements, judgments, claims, etc., March 1, 1913.—The rules for determination of values of intangible assets at March 1, 1913, are in many respects similar to those heretofore discussed. The position of the Treasury is set forth in a recent ruling. The taxpayer in the case secured a perpetual injunction in 1911 restraining an infringer of its patents.

RULING. Thus, on this date (July 31, 1911) a definite, assignable property right vested in the M Company.

The case was referred to a master of the court to ascertain and determine subject to the approval of the court the amount of said gains, profits and damages. The master filed a final report with the court on April 18, 1918, measuring the damages to be the loss or profit on the sales lost by the complainant. . . . .

In the latter part of 1918 the case was compromised, and the amount finally agreed upon and received was X Dollars. . . . .

In view of the foregoing it is held that the amount received in 1918 does not constitute taxable income for that year, for the reason that the right to receive this amount existed and was a part of the assets of the M Company on March 1, 1913. (Unreported to date.)

Value of goodwill at March 1, 1913.—The Treasury has indicated the following methods:

1. The difference between the price at which an article is sold under the trade-name and under no trade-name multiplied by the number of units sold during the year equals profits attributable to goodwill. Capitalize this at 20 per cent.

2. Comparison with businesses having similar sales and profits when such companies have goodwill purchased for cash.

RULING. . . . . The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow

out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles. . . . (C. B. 2, page 31; A. R. M. 34.)

Later[43] the Treasury held that the 10 per cent was to be applied to the *net* tangible assets. Of course, the smaller the average *net* tangible assets to be capitalized, the greater will be the earnings to be capitalized at 20 per cent to establish the goodwill value.

In businesses that are more or less stable, the Treasury suggests 8 or 9 per cent return on tangibles and capitalizes the earnings applicable to goodwill at 15 per cent.

Earnings of predecessor organization may be used.—

Ruling. In determining the value of good will as of March 1, 1913, in accordance with the third method outlined in A. R. M. 34 (C. B. 2, p. 31), and as a factor in the ascertainment of the value of a share of stock as of that date, a corporation which had not been in existence for a period of five years prior to that date was permitted to take the average earnings of the business for five years, thus including a part of the period of the partnership organization that preceded incorporation. (B. 52-21-1990; O. D. 1146.)

It would also be proper to use the earnings of a predecessor corporation. In reorganizations, consideration must be given to any abnormal conditions that may have affected adversely the earnings of the predecessor, such as change in product, need for reducing fixed charges, expansion of facilities, all of which may have prevented the former organization from showing large earnings, even though possessing a valuable goodwill on which the successor corporation was able to realize excellent profits in subsequent years.

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[43] C. B. 3, page 43; A. R. M. 68.

Deduction for federal taxes ascertainment of net earnings. The ruling quoted below is of particular interest not only in holding that federal taxes need not be deducted in arriving at net earnings for purposes of goodwill valuation, but because it clearly permits the taxpayer to consider only those ordinary expenses and costs which a prospective purchaser would take into account. Any extraordinary expenditures should be restored to income for the purpose of the computation.

A failure to cover sales commitments in a rising market resulted in a loss to one concern which had a very valuable goodwill and sold same for cash the following year at a high figure. The loss in question materially reduced its average earnings for the preceding five years. Such abnormal conditions require that the earnings record be studied with care. What is necessary is that a value shall be reached, after full consideration of all the factors, that would influence an intelligent purchaser, who would make due allowance for fluctuations in profits, trend of sales, excess plant capacity (if any), management, character of product, etc.

Ruling. . . . . Following the application of A. R. M. 34 employed in A. R. R. 252, the Unit, in the instant case, has determined the value of the intangible assets thus:

On November —, 1919, A sold the business of which he was sole owner. It was necessary to report as income the difference between the value of the business on March 1, 1913, and the price at which it was sold. An appraisal of the tangible assets was made at or about the time of the sale. Five years' earnings prior to the date of sale—that is, earnings for 1915 to 1919, inclusive—have been averaged and a rate of 8 per cent on the value of the tangible assets determined by the appraisal has been considered a fair return on such tangible assets and the balance divided by the difference between the selling price of the business and the appraised value of the tangible assets, which gives a percentage of 11.33 as the return on the good will. This ratio of 11.33 applied to the average earnings for five years prior to 1913 gave the value of the good will, etc., as of March 1, 1913.

In computing the earnings for the five years prior to the sale, Federal income taxes were not deducted. . . . .

In this discussion is to be kept constantly in mind that the objective to be attained is the value of the intangible assets as of March 1, 1913.

By value is here meant what a willing purchaser would be willing to give and a willing seller would be willing to take for such assets. In the absence of a sale as of the approximate date of March 1, 1913, it is recognized that any amount fixed will be at best only an approximation. The best method of determining this value yet suggested—and the employment of this method is not questioned by the taxpayer—is the capitalization of the net earnings of the intangibles. For this purpose it is necessary first to determine the net earnings of all the assets. In determining net earnings, both from an accounting standpoint and from a legal standpoint, it is necessary to deduct from the gross receipts cost of materials, cost of labor, cost of burden or overhead, and the amount of any other expenses not covered by these terms but which are not properly included in capital expenditures.

In determining the percentage to be used in the capitalization of the net earnings of the intangible assets of the particular business as of March 1, 1913, the Unit has tentatively determined the average earnings of intangible asets for the period of five years immediately preceding the date when the value of the intangibles was definitely fixed by an actual sale, but in computing the net earnings did not deduct, and now insists that it should not deduct, Federal income taxes for those years. During the years in question, 1915 to 1919, inclusive, with the exception of the year 1917, no tax was assessed upon an individual's business as such. The only tax which an individual paid was upon his individual income. This income, during all of the years in question, was, under the terms of the several Acts in force, made up of his receipts from all sources and the tax was levied upon the net income remaining after the allowable deductions had been made. Under no construction of the Revenue Act of 1913, or the Revenue Act of 1916 in its original form or as amended by the Revenue Act of 1917, or of the Revenue Act of 1918, could this tax be held to be an expense of any business in which the taxpayer was engaged during these years. The tax was not computed until all the expenses of such business had been deducted from the gross income, and no room appears for any serious contention that such tax would constitute a proper deduction in determining the earning power of the assets. . . . .

The real consideration presented by the inquiry of the Income Tax Unit, therefore, appears to be whether the war and excess profits taxes imposed upon the business of an individual by section 201 of the Revenue Act of 1917 should be deducted in determining the earnings for the year 1917 of the intangible assets employed in such business.

The value of the intangible assets to be determined, as above pointed out, is the value as of March 1, 1913. At that time no tax was imposed upon the business of an individual as such, nor was any in contemplation. Any tax not imposed until nearly four years later cer-

tainly was too remote to have been anticipated. Such a tax, therefore, could not have entered into the consideration of any prospective purchaser of a business in determining upon its worth to him. In determining, therefore, the rate per cent to be applied in capitalizing the net earnings as of March 1, 1913, it is believed that no other or different factors should enter into the equation than those which would have been used by a prospective seller and a prospective purchaser as of that date, even if it be conceded, for the sake of argument, that such taxes constitute expenses which would properly be deductible in determining the net earnings of intangible assets for the purpose of computing their value as of a later date. But the tax imposed by section 201 of the Revenue Act of 1917 is "a tax * * * equal to the following percentages of the net income." It seems reasonably clear, therefore, that the tax does not apply until all permissible deductions from earnings have been made and that the tax does not itself constitute a deduction in determining such earnings.

It is therefore held, in the case of A, that in determining the earnings chargeable to good will in accordance with A. R. M. 34 Federal income taxes are not to be deducted. (I-1-13; A. R. M. 145.)

The use of the average rate of earnings on intangible value during 1915-1919 as the basis for capitalizing actual earnings assignable to intangibles prior to 1913, is open to question. Rates of earnings and interest were both abnormally high during a considerable portion of the period of 1915-1919, and this was presumably taken into account by the purchaser of the property in 1919. He would certainly expect to capitalize abnormal earnings at a higher rate of return than earnings during a period of relative business depression such as some of the years preceding 1913.

When the earnings of the years immediately prior to March 1, 1913, were low, due to any abnormal condition, and the earnings of the years immediately following March 1, 1913, reflect a more normal situation, the capitalization of the earnings after March 1, 1913, is permissible.

It is admitted that great difficulty arises in determining the goodwill of a business which did not change hands at or about March 1, 1913. Less difficulty arises in the case of a corporation if a considerable number of the shares of its capital stock was sold at or about March 1, 1913. The following ruling is sound:

RULING. In determining the value of a corporation's assets, including good will, as at March 1, 1913, contemporary sales of stock are held to be of greater weight than values based on appraisal. (C. B. 1, page 73; O. 791.)

The foregoing ruling, however, cannot be applied if only a few shares were sold.

RULING. In applying the third method outlined in A. R. M. 34 (C. B. 2, p. 31), of determining value as of March 1, 1913, of intangible assets, individuals or partnerships in determining net earnings should deduct a reasonable amount on account of the salaries of owners actively engaged in the business. (C. B. 4, page 43; O. D. 937.)

Goodwill in relation to federal taxation.—The following discussion[44] calls attention to some of the most important points which one should consider when placing a value upon goodwill:

Goodwill is an intangible and fluctuating asset which represents the value of a business over and above the money, other tangibles and accumulated profits invested in it. . . . .

In actual sales and purchases the value has been computed in a variety of ways, among which are: (1) the aggregate of the entire earnings of a specified period; (2) a certain number (of years' purchase) times the average earnings in excess of a determined rate on the average tangible investment for several years; and (3) the capitalization of an average of several years' earnings at a specified rate, deducting therefrom the value of the tangible assets. It is undoubtedly true that in a number of cases the amount paid for goodwill represents only the difference between the book value and the sales price, which price is the result of a compromise between bid and asked prices with little or no regard to any of the above-mentioned methods of computation.

Goodwill has a value as a rule only when a business has earned and it is expected will continue to earn a rate on the invested value of the tangible assets in excess of a certain basic rate of return. The exception to the rule would be, for example, when a large amount of advertising has been done but sufficient time has not elapsed to show the value of this advertising. The excess of earnings arises from a number of factors, such as patents, reputation for integrity, trade-names, publicity from past advertising, location and a partial or complete monopoly. . . . .

[44] *Goodwill in Relation to Federal Taxation*, by N. J. Lenhart, Chicago office, Lybrand, Ross Bros. and Montgomery.

In general, investors in bonds, preferred stocks or common stock place considerable importance on the past earnings, reputation and the factors of goodwill (although perhaps not to the same degree), because no investor is willing to invest in a business which he does not believe is reasonably assured of continued success.

The rate of return (earnings to investment) that will attract investments in common stock in any particular industry cannot be reduced to a definite figure. The factors which affect the yield expected are:

1. A seasoned stock with a long-continued earning and dividend record sells at a lower yield than an unseasoned stock.
2. A business with stable earnings sells at a lower yield than a business in the same industry with unstable earnings.
3. A steady growth in earnings always attracts investors at a lower yield than an unsteady growth or no growth.
4. The liberality of the dividend distribution, marketability and sectional money rates have considerable effect on the yield expected.

It, therefore, seems reasonable to assume that there is no general rate of return necessary to attract investors in any particular industry.

If any particular business is in question and a rate of return which will attract an investor is agreed upon, the question arises as to whether the investor desires the agreed return upon his whole investment or if he desires the agreed rate on his investment in tangible assets and a higher rate on the amount invested in goodwill.

One method of computation which has been often used is to decide on the rate of earnings necessary to attract the investor, which may be 9 per cent, for example, and then to take, say, five times the excess of earnings over the 9 per cent on the investment during a specified period. Under this method the resulting rate of earnings on the new investment figure is always larger than the rate represented by 9 per cent, provided, as is nearly always the case, that the number of years used is less than 100 divided by the rate used, and so it might be concluded that the investor requires a higher rate of return on the amount invested in goodwill than on the balance of his investment.

That this is not generally the case is shown by:

1. In many instances a business is purchased in which goodwill is the bulk of the asset bought. This is particularly true when the goodwill consists largely of patents, or in the case of retail stores where the location is particularly favorable.

2. The purchaser expects to continue the business and further develop the goodwill. The various elements of goodwill, such as location, patents and trade-names, are no more likely to depreciate

than are the physical assets through misuse, obsolescence and poor management.

3. The Treasury Department has consistently refused to allow depreciation on goodwill purchased, which attitude assumes goodwill to be of a more permanent nature than the physical assets.

It is consequently reasonable to assume that a rate of return which will attract the investor is a rate on his entire investment including goodwill.

In view of the foregoing discussion there are two methods of goodwill computation at March 1, 1913, which seem desirable in two situations, namely: (1) when the business is sold and a price paid for the goodwill, and (2) in case there has been no sale and when the value at which goodwill is paid in for stock is to be determined or in the case of liquor interests in which the goodwill has been lost through enactments by Congress.

The procedure to be used in the first instance can best be shown by an illustration of an actual case. The facts are as follows:

Income in 1910	$150,000.00	Investment for 1910	$750,000.00
Income in 1911	160,000.00	Investment for 1911	800,000.00
Income in 1912	170,000.00	Investment for 1912	850,000.00
Total	$480,000.00		$2,400,000.00
Average	$160,000.00		$ 800,000.00

Per cent of return 20%

Income in 1917	$425,000.00	Investment for 1917	$2,000,000.00
Income in 1918	375,000.00	Investment for 1918	2,400,000.00
Income in 1919	322,000.00	Investment for 1919	2,800,000.00
Total	$1,122,000.00		$7,200,000.00
Average	$ 374,000.00		$2,400,000.00

Per cent of return 15.5%

In this case the amount actually paid for the goodwill early in 1920 was $1,000,000, which, added to the average investment of $2,400,000 gives a new average of $3,400,000. The earnings for 1917, 1918 and 1919 were 11 per cent on the $3,400,000, and it is quite evident that the investor expects to get not more than 11 per cent without further development of the business.

Now the earnings decreased during the period of 1917, 1918 and 1919, but increased in the pre-war years. Conditions were stable in 1910, 1911, 1912, whereas the years 1917, 1918 and 1919 were war-time years and a period of depression could be expected. Since when conditions are stable and the earnings show a steady increase, the risk is considered less and the expected yield is lower than when

the reverse is true, it follows that in 1913 an investor or the same investor would undoubtedly have been satisfied with considerably less than 11 per cent and certainly not more than 10 per cent. On the basis of $160,000 average earnings in the pre-war years and an expected return of 10 per cent, the business was worth at least $1,600,000 at March 1, 1913, and the goodwill then was worth $800,000. Due to the nature of the business, patents, location, reputation, etc., the earnings could be expected to continue for a minimum of seven years and probably longer without additional development. Seven times the average earnings over 10 per cent in the pre-war years shows a goodwill of $560,000, which is obviously low (this is demonstrated in the actual case just cited), and this method admits of more argument than the one used in the illustration. In case there are factors which make the pre-war period entirely different from the years preceding the date of sale, this method based on the actual sales price as illustrated above may be open to criticism, but as a rule it seems to be the fairest and least open to attack in case there has been an actual sale of goodwill.

In case there has been no sale of the goodwill a more or less arbitrary method must be adopted. Any method used will be open to discussion and it is of the highest importance to get as many comparatively definite factors as possible.

It has been demonstrated in the published Treasury Department's reports that in the pre-war years the great majority of industries earned less than 10 per cent upon the invested capital. It follows, therefore, that in most industries the rate which could be expected by the investor willing to pay an amount equal to or greater than the invested value of the tangible assets was less than 10 per cent. The variations in the rates expected by an investor between industries as a whole depend upon the risk involved. This risk varies directly with the number of years the profits of the industry can be expected to continue according to the character of the business.

The preferred stock rate expected in an industry varies much less between the various businesses in the industry than does the rate on common stocks; and the preferred stock rate is, therefore, much easier to obtain and less open to question.

If the expected rate of return on the investment in a business were known it would be easy to capitalize the average earnings at that rate and call the difference between the book value of the net tangible assets and the figure so found goodwill. But this rate is unknown and certainly could never be satisfactorily agreed upon. However, since the expected rate varies directly with the risk, the rate would seem to be about the rate of the average earnings to an investment figure made up of the book value plus a number of years times the average excess of earnings over the preferred stock rate. The number of years will be determined according to the risk.

The manner in which this method is used is as follows:

Income in 1910	$150,000.00	Investment for 1910	$750,000.00
Income in 1911	160,000.00	Investment for 1911	800,000.00
Income in 1912	170,000.00	Investment for 1912	850,000.00
Total	$480,000.00		$2,400,000.00
Average	$160,000.00		$800,000.00

Preferred stock rate was about 6% during 1912:

6% on average investment	$ 48,000.00
Average earnings	160,000.00
Excess over 6%	$112,000.00
Seven times excess over 6%	$784,000.00

The goodwill, as computed above, amounts to $784,000 as compared with $800,000 under the method previously discussed.

The preferred stock rate should be the rate in the industry in the locality of the particular business. This rate can be found with some degree of accuracy, and at least with a much greater degree of accuracy than the rate necessary to attract investors to the purchase of common stock. The rate should be the average over a period of not more than a few years prior to the date at which goodwill is to be computed.

If a standard line of industry is decided upon and the number of years' purchase to be used in that industry is agreed upon, the relative degree of risk and the number of years to be used in some other industry should result in no wide divergence of opinion. The number of years to be used in finding the average return on the investment need not be the same as the number of years' purchase used, since cognizance must be taken of any special features present and facts which make certain years abnormal.

The conclusion to be drawn from the foregoing discussion is that a set formula cannot be developed for the computation of goodwill, but each case should be considered on its merits. If there has been a sale of the goodwill the first-mentioned illustration or an adaptation of it would give the most accurate result.

If there has been no sale some variation of the second illustration should be issued.

In valuing shares of stock as at March 1, 1913, when there was no market value determinable, the Treasury applied a formula for fixing the value of goodwill:

Ruling. . . . . The Committee is of the opinion that the market value of shares of stock was what they would bring, and that the

best evidence of what they would bring is what such shares did in fact bring when offered for sale about that time in a free and open market. However, in the present instance, it is understood that there were no sales, and it is necessary to apply other tests, the market value in such case being deemed to be what a willing buyer might reasonably have been expected to pay or a willing seller to accept for the stock. . . . . A prudent investor contemplating an investment, usually takes into consideration primarily two factors; first, the safety of his capital, and second, the return on it which he may reasonably expect. . . . . (C. B. 3, page 47; A. R. R. 252.)

The formula set forth in the foregoing ruling is summarized below, using the figures given in the ruling:

1916

Tangible assets	610x	Average tangible assets (3⅓ years prior to sale)	586x
Selling price of entire common stock	1,200x		
		Average net income (same period)	112x
Paid for goodwill	590x	8% of 586x = (approx.)	46x
		Balance applicable to goodwill	66x

Percentage 66x to 590x = 11% (approx.) = percentage to be used in capitalizing average earnings at March 1, 1913, applicable to goodwill.

1913

Average tangibles (5 years prior to March 1, 1913)	258x
Average earnings	30x
8% of 258x = (approx.)	20x
Earnings attributable to goodwill	10x
Capitalizing 10x at 11.13% = (approx.)	92x = value of goodwill March 1, 1913.
Add, Book value of tangibles at March 1, 1913	232x
Value of total assets, March 1, 1913	324x
Deduct, Par value of preferred stock	50x
Value of common stock, March 1, 1913	274x

Adjustment by appraisals of various dates.—Most appraisals made either by taxpayers or disinterested third

parties are of some date other than March 1, 1913. If made within a short time before or after that date the books of account should afford sufficient data upon which adjustments could be based. When the date of the appraisals is more than a year before or after March 1, 1913, the application of book adjustments is not of itself evidence that the result would represent fair market value as of that date. Actual conditions at the date of the appraisals would have to be compared with conditions existing March 1, 1913. If it could be shown that building materials, labor and other elements of cost were substantially the same, and if normal depreciation were applied, there is no good reason why an appraisal of a date more than a year before or after should not form the foundation for an adjustment of book figures to conform to fair market value at March 1, 1913. The Treasury in a recent ruling (1-5-60; A. R. R. 747) has held that "retrospective" appraisals will be accepted "when the facts upon which the appraisals are based have been established by proof." The proof need be only such "as is ordinarily accepted in important business transactions of like character." The acceptance of such appraisals is an important departure from the Treasury's previous procedure. (For text of A. R. R. 747, see Appendix A, Chapter VIII.) The purpose for which an appraisal was made should always be stated, since it may be the controlling factor in its acceptance or rejection.

When the actual surplus at March 1, 1913, does not appear on the books of the individual, firm or corporation, the difficulty of the case is apparent, but the mere absence of definite recorded figures compiled and stated on that exact date does not preclude a legitimate inquiry at a later time and an endeavor to ascertain accurate data as of that date.[45] Much

[45] *Doyle v. Mitchell Brothers Company*, 247 U. S. 179, 38 S. Ct. 467, 62 L. Ed. 1054 (May 20, 1918). Case decided under the 1909 law: "Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts."

of the work of public accountants consists in stating accounts as of a past date, and their findings are almost invariably sustained by the courts. Therefore, if a corporation, say, in 1917, sets up in its books certain assets acquired before March 1, 1913 (but not carried on its books at any valuation, or at a low valuation), credits surplus and declares a large special dividend, it cannot be contended that there is there a distribution of *taxable* income, unless the undistributed earnings accumulated since March 1, 1913, are sufficient to cover the payment.

Comparative values of similar property.—

Ruling. In general, value as at March 1, 1913, of property, real, personal, or mixed, may be established by consideration of bona fide transactions in like property occurring on or about March 1, 1913, together with all other facts pertaining to such value. (C. B. 1, page 37; O. D. 7.)

Prorating land and crop values.—

Ruling. A purchased for a certain price land together with crops growing thereon. The basis for determining gain or loss upon subsequent sale of the crops is the difference between the cost, or if no part of the purchase price was assigned to the crops, the fair market value thereof at the time of purchase, and the selling price less cost of harvesting and marketing. (C. B. 3, page 49; O. D. 714.)

Average of stock quotations on March 1, 1913.—The question has arisen as to which price shall be accepted in case of the sale of stock listed on an exchange, which was sold at varying prices on March 1, 1913. A ruling has been issued covering this point as follows:

Ruling. "The fair market price or value of March 1" is held to be the fair market price or value as of the entire day of March 1, which, in the case of variation between "opening and closing price" for the day, would mean the average price for the day. This, however, would be conditioned upon showing that the *exchange quotation* represented the fair market price or value of the stock, as it is this "fair market price or value" which is to control, however that fact may be ascertained. (Letter to the Corporation Trust Company, signed by Commissioner W. H. Osborn, and dated November 21, 1916.)

In view of frequent references to the March 1, 1913, date it is worth while to note that in legal and commercial usage this refers to facts as they existed at the commencement of business on March 1, 1913. In the regulations the date January 1, 1909, is often used. In commenting thereon the Supreme Court of the United States has said "December 31, 1908, would have been more precise,"[46] meaning that as the date from which to measure changes in values, December 31, 1908, should have been selected instead of January 1, 1909. It may safely be assumed that if called upon to pass upon a case where there was a difference between prices at the close of business February 28, 1913, and the average of prices during the entire day of March 1, 1913, the Supreme Court would doubtless uphold the closing prices of February 28, 1913.

New York Stock Exchange prices on March 1, 1913, were substantially the same as on February 28, 1913, so the point probably is of little importance.

RULING. The value of shares of stock as at March 1, 1913, should be determined on the basis of market quotations as at that date instead of book values. (C. B. 2, page 30; A. R. R. 33.)

When only a few shares were sold before and after March 1, 1913, taxpayers may claim that such sales were not representative nor controlling. The Treasury itself supports the statement.[47]

Valuation of closely held stocks.—

DECISION. In appraising shares of stock held in a corporation whose sole property was an office building, the shares having always been held in one family and never sold, the contention of the executors was that the value of the shares should be determined by the earnings of the property, which were shown to have been from 2.18½ to 4.15½ per cent over a period of six years. The value was claimed not to exceed $50 per share and the federal authorities had valued it at $39 per share. [The par was $100.]

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[46] *Hays v. Gauley Mountain Coal Co.*, 247 U. S. 189, 38 S. Ct. 470, 62 L. Ed. 1061, May 20, 1918.

[47] See *Excess Profits Tax Procedure*, 1921.

The court held that capital stock representing a building in good condition must be considered as worth the amount originally contributed by the shareholders; that the stock represented the assets, suggesting this to be the foundation of the stock dividend decision (*Eisner v. Macomber*); that while earning power was of very considerable influence upon market value, it was but one of the elements and not the most important one; that the argument advanced would lead to the conclusion that where a corporation had been running at a loss, the stock would be worthless.

The fact that the stock in question represented a minority interest was held not material under the circumstances where the corporation owed no debts and where its property consisted of a large office building, well located in the heart of a growing city and where there had been no dissension among the stockholders. The shares were held worth par, one judge dissenting.[45]

Value fixed by appraisers of state court may be rebutted.—

RULING. The appraised value of stock as at the time of the creation of a trust estate, by appraisers of a State court, creates a presumption only that the stock is of the appraised value; this presumption may be rebutted by competent evidence to the effect that the stock was of another value than that appraised. (C. B. 1, page 38; A. R. M. 7.)

In one case the executrix was the residuary legatee. There was no direct inheritance tax in the state at that time; no question of commissions was involved; the real value of the stock did not seem to be a vital one to the appraisers, who in 1914 valued stock at $100 a share. The real value was over $500 a share. The Treasury allowed a reappraisal in this case because the value of $100 a share was merely nominal.

Pro rata method—how far valid.—The early regulations under both the 1909 and the 1913 laws[46] laid down the rule that in the case of certain appreciations in values extending through a period which began before the effective date of the law, the appreciations should be considered to have accrued evenly throughout the period. The taxable portion, consequently, should be determined by a prorating process which

[45] Note on *Succession of Coleman*, 85 Southern 43 (La.) appearing in the *Bulletin of the National Tax Association*, November, 1920, page 57.

[46] 1909 law, Reg. 31, 1909; 1913 law, T. D. 2201, February 8, 1916.

would make the amount taxable depend upon the relative length of the period elapsed before and after the act took effect. The Supreme Court has made it plain that this method, while in itself not illegal as a method, must be considered merely one way of ascertaining the value of the property at March 1, 1913. In certain cases it may be the best or the only way of estimating that value and in such cases the court has indicated its acceptability. In the presence of some less arbitrary and more accurate method of valuing property at the effective date of the law, the *pro rata* method is not to be considered valid.

In a case under the 1909 law, *Hays v. Gauley Mountain Coal Company* (decided by the Supreme Court of the United States, May 20, 1918),[50] the court pointed out the necessity of establishing the value of the capital assets on December 31, 1908, and commented as follows on methods of determining that valuation:

Decision. Whether this should be done by taking an inventory upon the basis of market values then existing, or whether the entire increment accruing between the time of acquiring and the time of disposing of the assets should be prorated as if it had arisen through a series of gradual and imperceptible augmentations, is a matter of detail, to be settled according to the best evidence obtainable, and in accordance with valid departmental regulations. Treasury Regulations 31, December 3, 1909, provided for inventories at the beginning and end of each year with respect to manufacturing and mercantile companies; and with regard to a sale of capital assets acquired prior to January 1, 1909, and sold thereafter, required that the amount of increment or depreciation representing the difference between the selling and buying prices should be adjusted so as fairly to determine the proportion of the loss or gain arising subsequent to the date mentioned; but without prescribing any particular method of doing this. Subsequent rulings required that sales of stocks and bonds should be regarded as sales of capital assets and accounted for accordingly under Regulations 31, and while still requiring inventories, resorted to the prorating method with respect to real estate, apparently on the ground that increases and decreases in the value of this class of property during particular periods could not be accurately determined. . . . .

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[50] 247 U. S. 189, 38 S. Ct. 470, 62 L. Ed. 1061.

The present case was heard upon an agreed statement of facts which contains nothing from which the value of the stock at the time the act took effect may be deduced, otherwise than by the prorating method that was adopted; nor is any objection made by the respondent to the application of that method. Hence there is no lawful ground for overthrowing the tax.

Again, in the case of *U. S. v. C. C. C. & St. L. Railway Co.*,[51] decided by the same court on the same day, the court remarked:

Decision. Just how this part (the portion taxable because accrued after the effective date of the law) is to be separated from that which previously accrued is a matter of some nicety, as we have shown in the *Hays v. Gauley Mountain Coal Co., supra* case, The circuit court of appeals adopted the theory of an inventory taken as of the time the act went into effect; and although the assets here under consideration were not acquired for the purpose of sale in the manner of merchandise, but were bought for investment, and hence were not inventoried on December 31, 1908, it accepted the stipulated fact that the stock had a regular market value of $57 per share on that date as supplying the lack of an inventory. This result accords with the views we have expressed in the cases referred to.

The Treasury has pointed out that the *Gauley Mountain Coal Company* case merely approved the prorating method when there is no better way of determining fair "value."

Ruling. In the year 1900 a taxpayer purchased two shares of corporate stock for an aggregate amount of 52 x dollars, and in 1915 sold the same shares for 36 x dollars. On March 1, 1913, this stock was quoted at 24 x dollars. The taxpayer claims that he is entitled to a deduction for loss upon the sale of stock to the extent of the pro rata part of the reduction from cost to sale price attributable to the period after March 1, 1913.

The excess of the proceeds of a sale in the year 1915 of stock acquired by the taxpayer prior to March 1, 1913, over the market value of such stock on March 1, 1913, determined according to "the best evidence obtainable," is income for such taxpayer for the year 1915, regardless of the fact that the sale price of such stock was less than the cost of such stock to the taxpayer. (C. B. 1, page 35; T. B. M. 73.)

In this case the Treasury held that the value of the stock on March 1, 1913, was "fairly shown by the market quota-

[51] 247 U. S. 195, 38 S. Ct. 472, 62 L. Ed. 1064.

tions on that date," which was a better measure than prorating, and therefore must be used. In view, however, of the Supreme Court decision in *Goodrich v. Edwards* (advance opinions, 65 L. Ed. 450), there is no taxable gain in this case as original cost exceeded the selling price. Under the 1921 law, also, there would be neither taxable gain nor deductible loss in this case.

Income Derived from Sale or Exchange of Property Acquired by Gift and Inheritance

A new provision has been inserted into the 1921 law whereby appreciation of gifts in the hands of the donor is taxable to the donee when the latter subsequently disposes of the gifts.

LAW. Section 202. **(a) . . . . (2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition; . . . .**

Gifts after December 31, 1920.—

REGULATION. In computing the gain or loss from the sale or other disposition of property acquired by gift subsequent to December 31, 1920, the basis shall be the same as it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. This basis in the hands of the donor or last preceding owner by whom it was not acquired by gift shall be determined under the provisions of article 1561 and the taxable gain or deductible loss from the sale or exchange shall be computed in accordance therewith. If the donee is unable to ascertain the facts necessary to determine such basis, he shall so state upon his return, and the Commissioner

shall if possible obtain such facts from such donor or last preceding owner or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date such property was acquired by said donor or last preceding owner. In order to insure a fair and adequate appraisal or determination of the proper basis, donors making gifts of property on or after January 1, 1921, should leave an accessible record of the facts necessary to determine the cost of such property (and its fair market value as of March 1, 1913, where pertinent). (Art. 1562.)

Gifts before January 1, 1921—bequests, devises or inheritances.—

REGULATION. In computing the gain or loss from the sale or other disposition of property acquired by gift on or before December 31, 1920, or by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of acquisition. The term "property acquired by bequest, devise, or inheritance" as used herein included (*a*) such property interests as the taxpayer has received as the result of a transfer, or creation of a trust, in contemplation of or intended to take effect in possession or enjoyment at or after death and, (*b*) such property interests as the taxpayer has received as the result of the exercise by a person of a general power of appointment (1) by will, or (2) by deed executed in contemplation of or intended to take effect in possession or enjoyment at or after his death. . . . . In the case of property acquired by gift, bequest, devise, or inheritance, prior to March 1, 1913, the taxable gain or deductible loss from the sale or other disposition thereof shall be computed in accordance with article 1561. In the case of property acquired by bequest, devise, or inheritance, its value as appraised for the purpose of the Federal estate tax or in the case of estates not subject to that tax its value as appraised in the State court for the purpose of State inheritance taxes shall be deemed to be its fair market value when acquired. (Art. 1563.)

The accepted principle of law is that property acquired from donors or decedents is capital in the hands of the recipients, and that under the sixteenth amendment to the Federal Constitution no taxable income can be imposed thereon. This principle was adopted in the 1913, 1916, 1917 and 1918 federal income tax laws. As to property acquired from decedents, the rule is followed in the 1921 law. As to gifts other

than from decedents, an attempt is made in the 1921 law to tax appreciation in the value of gifts made after December 31, 1920, when, as and if realized by donees.

Income from sale of property acquired by gift.[52]—Early in 1921, the House of Representatives passed an act[53] amending the existing law and ascribing to donees upon realization the same measure of gain as would have been realized by donors if the gift had not been made. The Act did not pass the Senate.

The act was meritorious so far as it reached palpable evasion of taxes upon actual profits. Taxpayers owned property which had increased tremendously in value since 1913. The taxpayers having received very favorable cash offers for their properties and being unwilling to pay any tax on the prospective profit, conveyed the property to their wives. Immediately after the conveyance the wives would sell the properties and under the 1918 and prior laws no tax could be assessed thereon. It was agreed that something should be done to reach this species of evasion.

Prior to January 1, 1921, if the recipient of a gift disposed of it during his lifetime, he reported as taxable income (if a profit was realized) the difference between the value of the gift the day it was received, or if it was received before March 1, 1913, its value on that date, and the amount realized. If the proceeds of the sale were less than the value on the date of receipt of the gift or on March 1, 1913, the resulting loss was an allowable deduction.

The state of New York attempted to tax donors at the time of making gifts,[54] on the gain measured by the difference between the cost to the donor and the value of the gift when made. The Appellate Division of the Supreme Court of the

[52] Section 202 (a-2).
[53] H. R. 14198, passed House of Representatives May 27, 1921.
[54] New York State Comptroller's Regulations, Art. 91; amended November, 1921.

state of New York held the act to be unconstitutional on the ground that no taxable income was realized.[55]

The 1921 federal law is as follows:

LAW. Section 202. (a) . . . . (2) **In the case of such property, acquired by gift after December 1, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition; . . . .**

The 1921 law[56] does not fall into the error of taxing the gift itself. The tax is only imposed upon actual realization by the donee of a gain measured by cost to the donor. As a means of reaching gains which should properly be taxed, the new provision is meritorious. A limit of time, however, should have been fixed. Palpable evasions of tax usually arose when sales were made immediately after transfers of property. In other words, the sales, in effect, were transactions by and for the ostensible donors. The gifts were not *bona fide*. When sufficient time elapses between the date of a gift and realization by donees, it may be assumed that the gift is *bona fide*.

Undoubtedly the legality of the new provision will be attacked. Donees in receipt of *bona fide* gifts cannot be held to realize "income" except to the extent of appreciation after the date of the gift. It is recognized in the 1921 and prior laws that property acquired from a decedent is capital in the hands

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[55] *People ex rel. Wilson v. Wendell*, 188 N. Y. Supp. 273; *People ex rel. Brewster v. Wendell*, 188 N. Y. Supp. 510.

[56] **[Former Procedure]** Under 1918 and prior laws, the basis of gain or loss regarding property acquired by gift was value at the date of the gift.

of recipients. It is difficult to discern any difference between *bona fide* gifts and bequests. The obligations imposed upon donees may be found to be unreasonable. In the case of husbands and wives or children it *may* be reasonable to require a statement of cost or value March 1, 1913, to accompany a gift. In many other cases the obligations are too onerous. Gifts to employees and servants frequently consist of shares of stock of closely held corporations or real estate or other property the cost of which to donors is uncertain and difficult to determine. Often there will be hesitancy to divulge the actual cost. In such cases the donee is unduly penalized.

The new provision works two ways. If constitutional it imposes on donees liability for tax when the donor would have realized a profit, but it opens up two opportunities to donors of which they will not be slow to take advantage. Heretofore, in order to transfer possible tax liability it was necessary to make irrevocable gifts. In many cases securities or other property declined in value after the date of the gift. The donor was unable to take advantage of the loss in case of sale. Under the present law donors will be able to wait almost indefinitely in the case of non-income bearing property before deciding whether or not to make the gift. If the property declines in value and the donor decides to sell it, he may deduct the loss. If it increases in value and the gift is made, the donee will pay the same tax as if the gift had been made earlier. Furthermore, donees may now make new gifts to former donors in which case the latter may deduct losses which under the 1918 and prior laws would only have been deductible by donees, i.e., the loss accrued after the first gift.

No income tax is imposed upon an estate for any appreciation in values which may exist at the date of death, but inheritance taxes are based on actual values.

Appreciation in value of gift is not income to donor.—The following ruling applies to the determination of taxable profit upon sale of any gift received prior to January 1, 1921. It

is immaterial whether the sale took place before, or takes place after, January 1, 1921, as the provision of the 1921 law taxing profits from property sold or otherwise disposed of on the same basis as though the property were in the hands of the donor or last preceding owner who did not acquire it by gift, applied only to gifts made after December 31, 1920.

RULING. . . . . In the case of a real and actual gift of property which has appreciated in value between the time of acquisition and the time the gift is made, the appreciation will not be the subject of income taxation, and the donee who sells it will return as income only any appreciation realized over its value when the donee actually became the owner of it.

On the other hand, a mere colorable gift is not to be treated as a gift at all, and an attempt by such colorable gift to evade taxation is fraud for which either party who participates therein may be punished. (C. B. 1, page 83; S. 1022.)

In view of section 202 (a-2) of the 1921 law, the Treasury will doubtless hold that this ruling does not apply to gifts made after December 31, 1920.

HOMESTEAD—VALUE AT DATE OF ACQUISITION.—

RULING. The basis for determining gain or loss from the sale of a homestead acquired from the Government will be the fair market value of the homestead at the date of its acquisition or the value at March 1, 1913, if acquired prior to that date.

The date of acquisition of a homestead acquired by public grant is the date of entry upon the land. The taxpayer will not be entitled to add to the value of the homestead the amount expended for relinquishment in order to clear the Land Office records, nor any fees paid to the Government, but the cost of improvements may be added to the value as of the date of acquisition. (C. B. 2, page 33; O. D. 386.)

The foregoing is based on the theory that a "public grant" is in the nature of a gift from the government.[57] Therefore the value used to compute profit or loss on sale is the same as that used in the case of any gift, viz., the value at date of acquisition if after March 1, 1913, and before Janu-

[57] Letter to the Corporation Trust Company, signed by Acting Commissioner Paul F. Myers, dated July 8, 1920.

ary 1, 1921. The procedure regarding such gifts after December 31, 1920, is a good test of one's imagination.

Income from sale of property acquired by inheritance.—

LAW. Section 202. **(a) . . . . (3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition.[58] The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402.[59] . . . .**

VALUE AT DATE OF TESTATOR'S DEATH MUST BE USED.—

RULING. In computing gain or loss on a sale of stock by trustees under a will, the value of the stock at the date of the testator's death should be used as the starting point rather than the value of such stock at the date of distribution to the trustees.

Any gain realized on such a sale must be reported as taxable income by the trustees, who will also be required to pay the tax due thereon. The fact that at some uncertain date in the future the corpus of the estate, including the accumulation of income of a certain character will, if it is then in existence be paid over to exempt corporations, does not relieve the trustees from the obligation of paying the tax. . . . . (C. B. 2, page 34; O. 1012.)

The last paragraph of the foregoing ruling is contrary to a recent court decision based on the 1916 and 1917 laws. (*Lederer v. Stockton,* 266 Fed. 173, writ of certiorari was granted by the Supreme Court October 25, 1920, 254 U. S. 625.)

RULING. Under the terms of a will the residue of the estate was bequeathed to the testator's three sons, to be divided equally among them. This residue consisting of cash and a number of securities was in accordance with mutual agreement divided upon the basis of the market price of the securities at the time of distribution, which was in excess of their value at the date of decedent's death, as appraised for Federal estate tax purposes. Following this arrangement one of the residuary legatees received no cash, another less cash than the third, but all received an equal share of the residue in

[58] **[Former Procedure]** Reg. 45, Art. 1562, provided that the value at time of acquisition should be the basis for property acquired by gift as well as by bequest, devise or descent.

[59] Section 402 (c) and (e) deals with the determination of the gross estate of a decedent for estate tax purposes. For details see Chapter XL.

accordance with the terms of the will. The question presented is whether the estate derived any taxable gain from the transfer of the securities to the residuary legatees and whether on a subsequent sale by the legatees the basis for determining gain or loss is the fair market value of such securities at the time they were received by the legatees in the distribution or at their appraised value as at the date of the death of the testator.

Held, that the estate of the decedent derived no taxable gain from the transfer to the residuary legatees of the securities forming a part of the residue of such estate. The basis for determining gain or loss upon a sale of securities received by legatees is the value of such securities at the date of the testator's death, as appraised for the purpose of the Federal estate tax, whether the devise or bequest be specific or residuary. (C. B. 3, page 53; O. D. 667.)

Where securities held in trust for the beneficiaries are subsequently distributed together with other securities representing investments by the executors, it is necessary to segregate the securities for purpose of determining any profit on sale by the beneficiaries.

RULING. Held, that the basis to be used in determining the gain or loss resulting from the sale of those securities which were part of the estate of the testator at the time of his death is the value of the beneficiary's vested interest in such securities as at the date of the decedent's death; that the basis to be used in determining the gain or loss resulting from the sale of those securities representing an investment made by the trustees after the death of the decedent is the cost of such securities to the trustees. (I-3-28; I. T. 1165.)

SECURITIES ARE TO BE VALUED AT DATE THEY ARE AVAILABLE, IRRESPECTIVE OF DATE RECEIVED.—

RULING. On the date of her divorce in 1919 a beneficiary under a trust instrument executed by her father became entitled to the delivery by the trustee of securities. Their value on this date is the basis for determining gain or loss from a sale, notwithstanding the fact that by mistake she did not receive them till two years subsequently. (B. Digest 51-21-1976; O. D. 1136.)

VALUE AS BETWEEN LIFE TENANT AND REMAINDERMAN.—

RULING. Where in a bequest of property the remaindermen have only a contingent interest prior to the death of the life tenant, the basis for determining gain or loss from a sale of such property by the remaindermen is its value as of the date of death of the life tenant. (C. B. 3, page 53; O. D. 727.)

WHEN INTEREST IS NOT CONTINGENT.—

RULING. Where real estate is devised by a testator to his widow for life with a direction that upon her death the property shall be sold and the proceeds divided among the testator's children, the basis for ascertaining the gain or loss on a sale of such real estate and distribution of the proceeds to the children is the value of their rights at the time they vested, or on March 1, 1913, if they vested prior thereto. . . . .

The possession of land devised to the children of a testator subject to a life estate in their mother, which vested in fact on the death of the life tenant, was acquired by the children *in right* on the death of the testator. The provision of the income tax law exempting from tax the value of property acquired by a devise or bequest merely exempts the value of the right at the time it was acquired and not any value which subsequently may attach to it pending actual or anticipated arrival of the period of enjoyment. . . . . (C. B. 3, page 50; Sol. Op. 35.)

In the detailed opinion the solicitor said:

Section 2(c) of the Revenue Act of 1916, in so far as the present question is concerned, is substantially the same as the provisions of section 202 of the Revenue Act of 1918, here involved. Law Opinion 649, upon a consideration and application of the former section, held that the basis for determining the profit from a sale of real estate by a remainderman after the termination of a life estate is the value of the property upon the date when the remainder vested in possession. That opinion is inconsistent with the view here entertained and is hereby overruled.

Capital Gains

Prior to January 1, 1922, the rates of tax imposed under all federal income and profits tax laws were the same upon capital gains[60] as upon ordinary net income. Under the 1921 law the maximum rate of tax upon net capital gains realized after January 1, 1922, is 12½ per cent.[61] As the rate includes

[60] "There are capital profits and revenue profits. Thus, for instance, part of a tract of land upon which a factory has been erected is sold for an amount equal to the original cost of the entire undertaking. This is realized income, but it does not fall within the ordinary definition, therefore it is not wise to rely upon any one definition. The net income from a man's vocation is revenue profit; the net profit realized from an outside venture is capital profit." [*Auditing Theory and Practice*, by R. H. Montgomery (1921 edition), page 309.]

[61] For computations, etc., see page 631.

the normal tax of 8 per cent, the maximum surtax is 4½ per cent. The provision does not apply to corporations, but as the flat tax upon corporations is 12½ per cent the inhibition is of no importance for the year 1922.

The law contains the following definitions:

LAW. Section 206. (a) That for the purpose of this title:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;

(3) The term "capital deductions" means such deductions as are allowed under this title for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain as defined in this section;

(4) The term "capital net gain" means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses;

(5) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year. . . . .

The provisions of the 1921 law with respect to the method and rate of taxation to be applied to capital gains realized after December 31, 1921, are as follows:

LAW. Section 206. . . . . (b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per

centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

Although the courts and economists do not agree on the distinction between capital and income, the language of the law is not ambiguous and there should be little difficulty in computing net capital gains.

In large part the regulations pertaining to the capital gain provisions of the law merely repeat in slightly different phraseology the language of the law itself and present a few illustrative figures to show the application of the provisions to concrete cases. The regulations do, however, touch specifically on two points which are not mentioned in the law itself. One is with reference to the case of a taxpayer who has a net capital gain and a net loss in ordinary income account. The regulations hold that the net loss in "ordinary net income" cannot be applied against net capital gain if the benefit of the 12½ per cent rate of tax on the capital gain is to be availed of. The other point is with respect to the question of whether the two-year period runs from the inception of an investment, the form (but not the substance) of which has changed but from which change under section 202 (c) no taxable profit or deductible loss is deemed yet to have arisen, or whether the two-year period runs from the time the investment took the form it had at the time of sale. Article 1561 (see page 570) holds that in such case the time during which the investment was in its previous form is included in the two-year period.

Regulation. (*a*) Section 206 applies only to sales or exchanges of capital assets consummated after December 31, 1921. It provides that any taxpayer other than a corporation may, if he so desires, state separately in his return his net gain on sales or exchanges of capital assets and pay on such capital net gain (as defined and limited in the section) a flat tax of 12½ per cent in lieu of the tax he would otherwise pay on such income under sections 210 and 211. On his net income from other sources, termed "ordinary net income" in this section, he would be taxed under those sections. If, however, he elects thus

to segregate his capital net gain, his total tax on the aggregate amount of both kinds of income must be at least 12½ per cent thereof.

DEFINITIONS: "CAPITAL ASSETS."—

The term "capital assets" is defined to mean property of any kind whatever acquired and held by the taxpayer for profit or investment for more than two years, whether or not connected with his trade or business, not including property (for example, a dwelling) held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind properly included in an inventory. The specific property sold or exchanged must have been held for more than two years, but in the case of a stock dividend the prescribed period applies to the original stock and the stock received as a dividend considered as a unit and where property is exchanged for other property and no gain or loss recognized under the provisions of section 202, the prescribed period applies to the property exchanged and the property received in exchange considered as a unit.

"CAPITAL GAIN" AND "CAPITAL LOSS."—

"Capital gain" is taxable gain from the sale or exchange of capital assets, while "capital loss" is deductible loss resulting from the sale of capital assets. As to the basis for determining such gain or loss (including adjustment for depreciation) see article 1561; as to betterments and repairs, see articles 24 (3) and 103. Ordinary repairs and taxes are annual charges against income, and do not enter into the computation of such gain or loss.

"CAPITAL DEDUCTIONS" AND "CAPITAL NET GAIN."—

"Capital deductions" are deductions properly allocable to or chargeable against items of capital gain, including items of expense connected with the sale or exchange of a capital asset (for example, commissions paid brokers or agents). While interest, taxes, and other carrying charges are usually annual charges against income, they may be allocated to capital gain derived from the sale or exchange of a capital asset for the taxable year in which such asset is sold or exchanged to the extent that such current charges exceed the income directly derived from such asset. "Capital net gain" is the excess of the total amount of the capital gain over the sum of the capital deductions and capital losses.

COMPUTATION OF CAPITAL NET GAIN AND TAX.—

For illustration: A in 1922 sold (1) an office building for $1,000,000 which he had bought in 1915 for $500,000 and on which

there was depreciation aggregating $100,000; and (2) stock in a mining company for $10,000 which he had purchased in 1919 for $20,000. Taking no account of capital deductions (for example, commissions paid on these sales), his capital gain would be $600,000, his capital loss $10,000, and his capital net gain $590,000. Suppose that his other net income ("ordinary net income") in 1922 was $50,000. Instead of paying normal tax and surtax on his total net income of $640,000, he may segregate these capital transactions in his return and pay a tax of 12½ per cent on his capital net gain of $590,000, plus the normal tax and surtax upon his ordinary net income of $50,000. Suppose, on the other hand, that A, with capital net gain of $590,000, not only had no "ordinary net income," but actually sustained a net loss of $50,000 in his business. He may not deduct such net loss in "ordinary net income" from his capital net gain if he elects to be taxed under section 206, but must pay 12½ per cent of $590,000. . . . . (Art. 1651.)

The illustration in article 1651 quoted above may be stated in tabular form as follows:

1922	Selling price of office building		$1,000,000	
1915	Cost price of office building	$500,000		
	Less: Depreciation	100,000	400,000	
	Capital *gain*			$600,000
1919	Cost of mining stock		$ 20,000	
1922	Selling price of mining stock		10,000	
	Capital *loss*			10,000
	Capital *net gain*			$590,000
	Other income ("ordinary net income")			50,000
	Total net income			$640,000
				Tax
	A pays 12½% on $590,000			$ 73,750
Plus:	Normal tax:			
	Ordinary net income		$ 50,000	
	Less: Exemption (if married and having no dependents)		$ 2,000	
			$ 48,000	
	Taxable at 4%		4,000	160
	Taxable at 8%		$ 44,000	3,520
	Surtax (1922 rates) on $50,000			4,960
	Total tax			$ 82,390

The tax computed without benefit of the capital gains provision would be:

Normal tax:		
Normal income	$ 640,000	
Less: Exemption	2,000	
	$ 638,000	
Taxable at 4%	4,000	$ 160
Taxable at 8%	$ 634,000	50,720
Surtax on $640,000		290,960
Total tax		$341,840
Difference		$259,450

In the second case assumed in the illustration		
Capital *net gain* is the same as before		$590,000
But instead of other income ("ordinary net income") of $50,000, A sustained a net loss in business of	$ 50,000	
Such net loss is not deductible from the $590,000 capital net gain which is taxed at 12½%.		

The net loss of $50,000 from business, mentioned in the illustration, should not be confused with the "net loss" described in section 204 (see Chapter XXIX), which may be carried forward to the succeeding year. The $50,000 net loss shown in the illustration is merely a factor in the alternative computation under the capital gains provisions Section 206.

On the other hand, assume that A's capital gain is		$100,000
and that A's net loss from business, as before, is	$50,000	
If A computed the tax under the capital gains provision, the tax would be 12½% of $100,000, or		$ 12,500

If A does not elect to be taxed under the capital gains provision, the tax will be computed as follows:

Normal tax:		
Net income ($100,000 — $50,000)	$50,000	
Less: Personal exemption	2,000	
	$48,000	
Taxable at 4%	4,000	$ 160
Taxable at 8%	$44,000	3,250
Surtax on $50,000		4,960
Total tax		$ 8,640

It is obvious that A in the illustration just given would not invoke the capital gains section of the law. The point is that losses which may not be deductible in computing capital gains may be taken in computing net income in the regular way. Alternative computations will have to be made so the taxpayer can determine which yields the lower tax.

Application of credits and exemptions in alternative computations.—

REGULATION. . . . . (*b*) The credit allowed by section 222[62] . . . . is a credit against the total tax, however computed, but the credits allowed by section 216[63] are allowed "for the purpose of the normal tax only" and may not be taken against capital net gain, although they may be deducted from ordinary "net income." For example, if B, a married person, had capital net gain of $30,000 and ordinary net income of $2,000, his $2,500 personal exemption would more than offset his ordinary net income, but he may not apply any part of it to reduce his capital net gain. . . . . (Art. 1651.)

Tax not less than 12½ per cent of total net income.—

REGULATION. . . . . Section 206 (b) provides that if the taxpayer elects to be taxed under that section his total tax shall in no case be less than 12½ per cent of his total net income. In the example just given, the tax on B's capital net gain of $30,000 at 12½ per cent would be $3,750, but the corrected amount of his total tax under this limitation is 12½ per cent of his total net income of $32,000, or $4,000. It will be found, however, that B, with ordinary net income of $2,000 and capital net gain of $30,000, would not elect to be taxed under section 206 because under the surtax rates for 1922 his total tax computed in the usual way would be only $3,940 (normal tax $2,240 plus surtax $1,700), or $60 less than if computed under section 206. . . . . (Art. 1651.)

The tax in the foregoing illustration is computed thus:

(1) On basis of capital gains	$3,750
(2) On basis of applying the limitation of 12½% to total net income	$4,000
(3) On ordinary basis, disregarding capital gains provision	$3,940

B pays the last of the three taxes.

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[62] Section 222 refers to credit for foreign income and profits taxes.

[63] Section 216 provides for credit of certain dividends and interest, and for the personal exemptions and credits for dependents.

Effective date.—The law refers to transactions "consummated after December 31, 1921." It is clear that sales or exchanges which were entirely completed before January 1, 1922, cannot be reported in 1922, but are subject to the rates in force prior to 1922. Irrespective of the new regulations, the attitude of the Treasury must be that the word "consummated" as applied to the taxation of income, means actual realization and not a "paper" closing of a transaction. There will be cases in which doubts will arise as to the actual consummation of a transaction, and in some cases the decision will throw the gain back of 1922 and in almost similar cases the gain will be held to be realized in 1922. Generally speaking, transactions prior to January 1, 1922, which did not result in the receipt of cash or property of a readily realizable market value, were not consummated on the effective date, and the gains arising from such transactions should not be reported until they are actually consummated.

Meaning of term "capital assets."—Upon the interpretation given to the term "capital assets" will depend the classification of items which heretofore have not been carefully earmarked as capital items because no necessity existed for a correct classification. It is immaterial what terminology may have been used by taxpayers in the past. The sole test hereafter will be the true designation of items. The law clearly sets forth three negative tests which permit easy classification:

1. Capital assets must have been owned for at least two years.
2. Stock-in-trade must be excluded.
3. Property held for personal use or consumption must be excluded.

Meaning of two-year requirement.—In imposing a low rate of tax it was the intention of Congress to encourage the transfer of investments. It had been claimed that property held for a long period of years could not profitably be disposed of

under the high rates of tax. The argument did not extend to gains arising from property recently acquired. With this in mind it should not be difficult to follow the two-year limitation. Taxpayers who claim the benefits of the special rate must show that the assets from which the taxable gains arise have been "acquired and held by the taxpayer" for more than two years prior to date of sale. The property disposed of must be the identical property acquired more than two years previously, unless the existing property is held *for income tax purposes* to take the place of other property.

In all cases which are held not to be closed transactions the two-year period runs from the date the original property was acquired. There are difficulties in applying this principle. When real estate which is real property has been exchanged for shares of stock which are personal property, it can hardly be held that the capital asset disposed of is the real estate even though one is held to take the place of the other and no tax was imposed upon the exchange.

It may be held that capital assets disposed of must have been held for two years in their identical form although the basis of tax may go back to the original cost of property for which the property sold was exchanged. The section must be reasonably construed. A building is a capital asset. Suppose it is substantially rebuilt within two years prior to sale. The building as sold has not been held for two years but the capital asset has been held for two years. In other words, a mere change in form should make no difference.

Assets (other than stock-in-trade) owned by partnerships and distributed to partners at book values, are capital assets in the hands of the partners. The two-year period runs from the time the assets were acquired by the partnership.

Meaning of term stock-in-trade.—Without going into refinements of terms it is sufficient to state for income tax purposes that stock-in-trade is that which the Bureau of Internal Revenue has held to be stock-in-trade. There have been many

exclusions of what might have been called stock-in-trade under commercial practice. For instance, dealers in real estate do not own stock-in-trade. All of their assets are capital assets. Taxpayers engaged in business should be careful hereafter to analyze their income statements. It is not considered good accounting practice to credit to current income gains arising from sales of capital assets; but it is quite easy for a bookkeeper to make such entries. In the past it has made little difference. In the future it may make a substantial difference.

The Treasury has ruled that inventories may be taken only of merchandise and of securities; in the case of securities permission to inventory is strictly limited to dealers in securities. Many who have called themselves dealers in securities have been refused the classification by the Treasury.[64]

Article 1585 of Regulations 45 made a distinction between corporations and partnerships which were dealers in securities and "officers of (such) corporations and members of (such) partnerships, who in their individual capacities buy and sell securities," holding that the officers and individual partners were not dealers in securities. They were not permitted to inventory their securities and obviously therefore their securities could not be considered "stock-in-trade."

The Treasury recently has ruled[65] that "a taxpayer, engaged in the real estate business, is not permitted to inventory real estate which is held for sale for the purpose of calculating net income subject to federal income tax." Under this ruling the gain on real estate owned for more than two years will carry the $12\frac{1}{2}$ per cent rate. In the case of bankers and others who have carried securities for more than two years and which have not been inventoried, *for federal tax purposes*, they may sell them and the gain, if any, will be taxed at $12\frac{1}{2}$ per cent. In any event, accounting practice determines which assets should be inventoried. Those which should not be, are capital assets, irrespective of erroneous methods of accounting.

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[64] *Income Tax Procedure*, 1921, page 359.
[65] C. B. 4, page 47; O. D. 848 (March 23, 1921).

In some cases inventories of stock-in-trade improperly include capital items such as machinery parts, building materials, etc. In case of resale at a gain the items should be segregated; otherwise the practice has no effect on the computation of capital gains.

FORMER DEFINITIONS OF TERM "CAPITAL ASSETS" NOT BINDING.—The Treasury in the following case has defined the term "capital assets."

RULING. In the case of a bank the term "Capital Assets" as used in article 545 of Regulations 45 includes bonds and other securities in which it has invested money received on deposit. Any gain derived by the bank from the sale of such securities must be reported in its gross income and the amount of the gain is to be ascertained in accordance with the rules laid down in that article. (C. B. 4, page 276; O. D. 832.)

Ordinarily definitions such as the foregoing will not affect the specific definitions contained in the law. In the case of banks all of their investments are capital assets unless they were permitted by the Treasury to inventory their securities, having first qualified as dealers in securities.

The mere act of calculating depreciation or depletion has much to do with the determination of stock-in-trade. The latter is periodically revalued for income tax purposes. Under the regulations assets which could not be inventoried, automatically become capital assets.

MEANING OF TERM "PERSONAL USE OR CONSUMPTION."—Taxpayers are not permitted to deduct as losses, nor permitted to return as capital gains, the losses or gains arising from the sale of residences occupied by the taxpayers, automobiles, jewels and similar items (article 1651, see page 570). The inhibition is fair so far as losses are concerned, but not fair regarding gains; if such gains are taxable at all they certainly should be taxed as capital gains.

All property, including residences leased to others, and in-

vestments of every description, excluding only assets for personal use or consumption, are classed as capital assets.

Determination of "net" capital gains.—The law states that "net" capital gains consist of capital gains minus capital losses. Having decided which assets are capital assets, the calculation of the net gain or net loss is comparatively simple, and being fully discussed elsewhere, need not be repeated.[66] A short formula is the following:

Debit an account with value of asset at March 1, 1913, or cost if acquired since; add capital expenditures such as carrying charges if capitalized (that is, if not deducted in tax returns since 1913); credit depreciation or depletion to date of sale; credit net sales price. The balance of the account will be the capital gain or capital loss.

Net capital losses.—The law does not impose the limitation of 12½ per cent upon net capital losses. Taxpayers who seek to secure the maximum benefit under the new law will endeavor to bunch their capital gains in one taxable year and their capital losses in another taxable year.

For discussion see page 627.

Statement of capital transactions to be attached to return.—

REGULATION. Segregation of capital transactions for the purposes of section 206 is required only where the taxpayer elects to be taxed under that section. Where his total income tax for any taxable year does not exceed 12½ per cent of his net income he will not elect to be so taxed for that year. . . . . When a taxpayer elects to be taxed under this section for any taxable year, he shall attach to his return of income for such year an accurate statement under oath showing all items of capital gain, capital loss, and capital deductions in such manner as will clearly show the exact amount of his capital net gain for the taxable year. Each capital transaction must be separately shown and the capital items with respect thereto grouped

[66] See page 573, where effect of depreciation on sales is discussed, and computations on page 577 showing effect of depreciated March 1, 1913, value, and depreciated cost, respectively

together in order that the capital gain derived or the capital loss sustained from each capital transaction will readily appear. In the case of sales or exchanges of real estate, the statement must show whether or not it was held as a residence by the taxpayer or his family. In the case of sales or exchanges of securities or any other property, the statement must show how long the property was held by the taxpayer immediately preceding the sale or exchange. (Art. 1652.)

CHAPTER XVIII

INCOME FROM ROYALTIES AND PATENTS

Income from royalties and similar sources is not specifically named in the definition of income in the law, but it is clearly included within its terms.

LAW. Section 213. . . . . **the term "gross income"— . . . . (a) Includes . . . . gains, profits and income derived from any source whatever.**

REGULATION. . . . . gross income . . . . embraces . . . . income . . . . such as . . . . royalties . . . . (Art. 541.)

The law provides that the profit which arises from the sale of patents and copyrights must be included as income for the year in which it is received. It has been pointed out on many occasions that this procedure works an unwarranted hardship on inventors and others who have spent considerable time and money in the development of ideas or devices, only to find that on selling them the whole of the increased value must be returned for tax purposes in a given year. While it is admitted that proration of the increment over the development period would be extremely difficult, nevertheless the present procedure burdens the unfortunate inventor or author.

Under the 1918 and prior laws no relief is granted, nor is any effective for the taxable year 1921; but for 1922 and subsequent years the "capital net gain" provision of the law (section 206) will limit the tax payable to 12½% of the profit, if the patent or copyright has been held for at least two years.[1]

Royalties from Mines, Oil Wells, etc.

Royalties from mines, oil wells, etc., must be included in gross income for the year in which they are received. This

[1] See further Chapter XVII.

procedure applies even if the title to the producing land is in question.

Rulings. Income from oil royalties must be returned in the taxable year received, even though the title to the producing land is in litigation. If any part of the royalty income is ordered by the court to be paid over to another, any tax previously paid thereon will be credited against any income tax then due under any other return of the taxpayer, and any balance of the excess tax paid will be refunded if proper claim for such refund is made. (C. B. 4, page 95; O. D. 825.)

This ruling was later explained as follows:

In the case of a dispute as to the title of oil-producing land, the royalties belong to the true owner. They follow the land and come into existence regardless of the person or activities of the owner. If one collects the royalties thinking he is the owner and then by judgment of court finds that another is the owner, he must surrender the royalties received not as damages but simply because they belong, and belonged from the beginning to the true owner. The one who first received the royalty did so because he thought the land, and therefore, the royalties were his.

Where a patentee obtains a judgment against the infringer of a patent by virtue of which the infringer must account for all profits made through the infringement, the situation is materially different. The infringer of a patent directly creates by his activities the profits made; but for him they might not have come into existence. These profits as earned belong to him and are properly returned as income in the years earned. But having committed a wrong in infringing the patent he is compelled to compensate the owner for the damage done him and the measure of such damage in equity is the profit derived by such infringement and such further amount as the Master may find. A judgment requiring an accounting of profits, in such a case, is the equivalent or substitute for legal damages. It does not mean that the profits made by the infringer belong to the owner of the patent from the time such profits are made and that the infringer is converted into a trustee for the owner with respect to such profit. (*Tilghman* v. *Proctor,* 125 U. S. 136; *Root* v. *R. Ry. Co.,* 105 U. S. 214.) With this understanding of the nature of judgments requiring an accounting of profits in patent infringement cases it is clear that the loss sustained by the infringer must be taken in the year judgment is rendered. (B. 51-21-1981; O. D. 1141.)

Royalties subject to depletion charges.—The owner of a mine, an oil well or other similar property operated on a

royalty basis must return as income his royalties received, but he is permitted to deduct expenses and to charge against receipts depletion allowances based on the full value of his property as at March 1, 1913, if purchased before that date, or on the basis of the capital originally invested if purchased thereafter,[2] except in the case of mines and oil wells discovered by the taxpayer, in which case the value of the property at the date of discovery or within thirty days thereafter is the basis prescribed by law.[3] For a full discussion of the topic of depletion as an allowable deduction, consult Chapter XXXIII, "Depletion."

After the value as at March 1, 1913, is determined, a proper calculation must be made as to how much of the royalties received is capital and how much is income. The part which is capital cannot be taxed, but all royalties which accrue must

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[2] *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 61 L. Ed. 460, 37 S. Ct. 201.

[Former Procedure] Full depletion allowances have been permissible deductions only since 1916. The 1913 law contained a provision restricting such charges to 5 per cent of the gross value of the output of the mine, and in spite of the fact that this worked inequitably in some cases the courts decided that it was constitutional. The 1909 law permitted no deduction at all for depletion. As it is still frequently necessary to pass upon returns made under the 1913 law, the following decision issued February 12, 1915, is of interest:

"In the case of mines operated by a lessee on a royalty basis, it is held that the lessor in disposing of his ores or natural deposits on the basis of royalties has a measure of profit in every ton of ore disposed of in this way, and that so much of the gross receipts on account of royalties as is in excess of depletion, not exceeding 5 per cent of the gross value of the output at the mine, plus any incidental expenses to which the corporation may be subject, is income within the meaning of the federal income tax law and should be so returned by the lessor." (T. D. 2152.)

The above ruling was obviously defective because it ignored the fact that there are many cases where royalties received have no "measure of profit" in them. Every purchaser or owner of a mine or oil well does not have a bonanza. He may have paid a high price for his property, hoping to secure royalty returns which would show a handsome profit, but his hopes may fade and disappear and he may be glad to get his original capital back without interest.

[3] Section 214 (a-10).

be reported as gross income and the depletion allowance must be deducted in order to ascertain the taxable or net income.

In the *Manual for the Oil and Gas Industry* the Treasury states (page 29) that "if a certain proportionate part of the lessee's capital returnable through depletion deductions is deducted in a given year the same *proportion* of the lessor's capital sum returnable through depletion will be deducted."

This rule may or may not be equitable. No general rule can deprive the lessor or lessee of the right to a depletion allowance which will return his capital free of tax.

Ruling. Land was purchased in 1914. At the time of the purchase the mineral rights in the land had no market value, that is, no part of the purchase price of the land was paid as consideration for the mineral rights therein. Subsequently the land was leased on a royalty basis for oil and gas development and in 1919, amounts were received from the sale of interests in such royalty.

Held, that inasmuch as the oil and gas rights had no market value at the time the land was purchased the entire amount received from the sale of the royalty interests is income for the year of its receipt, subject, however, to proper adjustment on account of depletion sustained. (C. B. 3, page 89; O. D. 644.)

The ruling is inconsistent. It first states that there is no capital investment, and then that an adjustment is to be made for "depletion sustained." The amount of depletion, when there is no capital sum to be depleted, must be rather difficult to determine.

The following ruling deals with a participating lease of oil lands.

Ruling. B acquired a lease of oil land, agreeing that the lessors should receive a one-sixth royalty interest in the lease. In consideration of the lease he also agreed to pay x dollars to the lessors from one-half the proceeds of all sales of oil and gas produced by the five-sixths working interest belonging to him in the lease and one-fourth and one-twelfth of the proceeds of the sales of oil and gas produced by him upon two other leases he owned. Under the agreement he was obligated to pay Federal income tax upon the sums payable, together with interest, the taxes and interest being payable in the same manner as the x dollars.

The oil is piped direct to the purchasing company, which remits to C, who places to the credit of the lessors amounts properly payable

to them. Upon forfeiture of the lease B is bound to pay the x dollars taxes and interest, and he may not sell the lease without paying these amounts.

Held, that all income received from the five-sixths interest belonging to B and the one-fourth and one-twelfth interest in the two other leases represent income to B for the year in which received or accrued, proper deductions being taken for depletion each year.

The x dollars may not be amortized over the period required for its payment, but so much of each payment as represents a payment on such principal amount, income tax payable, and interest upon the payments, should be claimed as a deduction for the year in which paid. (B. 28-21-1723; O. D. 971.)

Royalties from coal lands.—In the anthracite fields many owners of coal lands have granted perpetual "mining leases" to operators. The Supreme Court of Pennsylvania has held these transfers to be "sales."[4] In all cases the revenue therefrom (usually a fixed rate per ton mined) is known as "royalties." Under the 1916 and subsequent laws, the owners of coal lands, or those to whom a "royalty" is being paid, are entitled to receive in cash, free from income tax, an amount equal to the fair value of the property on March 1, 1913, if the property had been acquired prior to that date. This valuation is assumed to be capital. After such principal sum is provided for, the balance of the collections is income and is subject to the income tax. If the rate of royalties is a substantial one, it is probable that, of the royalties received each year, part is capital and part is taxable income.

A lease to mine coal in Pennsylvania provided that the lessor should retain the privilege of selling the property at the expiration of ten years. The Treasury held[5] that such a lease was not a sale of the coal in place, but the deduction for depletion was held to be the same as if the lease were a perpetual one.

Mining royalties (minimum) received in advance.—In most mining districts it is customary for owners of the lands

[4] *Hosack v. Crill,* 204 Pa. St. 97, 53 Atl. 640.
[5] C. B. 2, page 143; S. 1365.

to execute contracts or leases under which the lessees are required to make annual payments representing a fixed per-ton compensation or royalty for a definite number of tons of ore or coal. These payments are made to the owners and are clearly understood by both parties concerned to be in full payment of royalties for an equivalent amount of ore or coal whenever it may be removed thereafter. These payments are usually designated as advance minimum royalties, and may be paid for several successive years in which no ore or coal is mined.[6] In many cases the property is surrendered to the lessors before the quantities paid for have been removed.

Depletion applicable to royalties.—

Regulation. . . . (*b*) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

Both capital and income accounts must be adjusted.—

(*c*) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid. (Art. 215.)

[6][Former Procedure] See *Income Tax Procedure*, 1919, page 288.

The foregoing regulation properly holds that when a lessor has claimed annual depletion equal to the quantity covered by the advance royalties, no further deduction shall be made when the ore is subsequently removed.

The regulation further provides that when a lessor repossesses the property, and part of the ore or mineral, in respect of which depletion was deducted, has not been removed by the lessee, the aggregate of the excessive deductions will be deemed income to the lessor "and his income account shall be adjusted so as to include the amount . . . . as income of the year such lease is terminated or the property repossessed, and the tax thereon paid."

This latter provision may work great hardship. A lessor may lease coal lands for a period of thirty years at a stated royalty per ton for coal removed, the minimum royalty being fixed at $25,000 per annum. If the proper depletion based on the minimum royalty is $10,000 per annum, there is returned as net income $15,000 annually. If the lessee should mine only one-half of the coal paid for (and in many cases the proportion is less), in the thirty-first year the lessor would be presumed to have realized a net income of $150,000 and the tax thereon might be $50,000. Theoretically, excessive depletion, to the extent of $5,000 per annum for thirty years, has been claimed; but the tax saved by the excessive deduction may not have amounted to more than one-half of the tax which would be payable if the adjustment were made in the year of repossession.

Furthermore, the taxpayer probably would have no means of paying the tax, because a repossessed coal mine has little, if any, sale value.

In most cases the apparently excessive deductions would not be excessive at all. Depletion could only be charged from year to year on the basis of the original value of the lease. The lessee would not relinquish possession and lose his advanced royalties if the mine retained its value. Therefore, at the end of the period the lessor would have merely charged

off an aggregate sum equal to the depletion of the coal removed plus the depreciation in the value of his property.

In any event the actual value of the property repossessed is the maximum amount which can be deemed to be income. If amended returns for prior years are not accepted, the author ventures the prediction that no court would deem the value of the property repossessed to be income taxable solely in the year of repossession.

When the failure to recoup the advanced royalties or the lapse of the lease is due to inefficient operation, inadequate capital owned by the lessee, or for similar reasons other than the content, availability, etc., of the mine, and when the allowance in previous years for depletion, which never actually accrued, has resulted in real income not yet reported, amended returns should be made by the lessor. Also, if advanced royalties become unrecoverable because minerals have not been removed during a definite period stipulated in the lease, within which advanced or minimum royalties may be recovered, there may be some additional income of the lessor for previous years for which amended returns should be made.

Royalties waived for several years—received in one year.—

Ruling. A lessor of mining property who waived his right to royalties for several years on account of the fact that the mine was operated at a loss, and received all of the royalties in the year 1917, may, if he has submitted returns for those years on a cash receipts and payments basis, deduct from the income received in 1917 such depletion allowance as appertains to that income. (C. B. 2, page 144; A. R. M. 17.)

Royalties from Copyrights

An author should report as gross income all sums received from copyright privileges. He is entitled to claim as deductions all expenses, except ordinary living expenses, incurred in producing such income.

The argument which appears on page 640 for a more equitable tax upon the earnings of inventors applies with

equal force to the earnings of authors. It must be admitted, however, that there will be great difficulty in framing and administering a remedial provision. A lawyer who works for ten years and finally wins an important case has an equal claim to consideration.

REGULATION. . . . . Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. . . . . (Art. 293.)

However, deductions can be made for depreciation[7] and conservative accounting calls for rates of depreciation on assets of this kind up to 100 per cent per annum.

The method prescribed for computing the profit, if any, from the sale of copyrights, is the same as that for patents.[8]

The British practice as to copyrights is as follows:

BRITISH PRACTICE. (1) Annual payments of fixed amount, or being a fixed share of profits, are assessed on the person making the payment in the same way as interest.

(2) An author, playwriter, or artist selling copyrights, etc., to publishers is chargeable on the amount received less his expenses; if sold on royalty, the whole amount of the royalty is chargeable.

(3) No charge is made upon a person who has an isolated transaction of such a nature; the profit is looked upon as capital. [Murray and Carter, *Income Tax Practice* (1919 edition), page 219.]

Royalties and Profits from Patents

Income from the sale of patents above cost, or from royalties when such royalties include profit over and above the return of capital, is taxable.[9] The general principle of a return of capital must be followed, however. No tax can be imposed on receipts from the sale of patents or patent rights unless the owner has made full provision to reimburse himself for the cost or value of them. If the patents were applied for or owned on or before March 1, 1913, their actual value at

[7] See Chapter XXXI, "Depreciation."

[8] Art. 40, page 652.

[9] [Former Procedure] For a short time the Treasury in taxing royalties ignored March 1, 1913, values. For rulings in 1916, see *Income Tax Procedure*, 1920, page 395.

that date is their capital value. If they were acquired after that date, the cost is considered the capital value.[10]

A payment to bind an option to purchase an interest in the royalties to be received from certain patents has been held to be income to the recipient.[11]

Damages received from infringements of patents.—Collections of damages arising from infringements may be income or capital or both, depending on the fair value as at March 1, 1913, and the nature of the damages collected. If no injury to the capital value has resulted, the entire collection, less expenses, is income.

If the capital value has been diminished by the infringement, the amount collected, or an appropriate part thereof, should be applied in reduction of the book value of the patents.

REGULATION. . . . . A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. . . . . (Art. 51; Reg. 45, Art. 52.)

The foregoing regulation may be applicable to most cases of recoveries arising from judgments, but there are many exceptional cases which must be decided according to other sections of the law and according to the decisions of the courts which define taxable income.

As stated above, the fair value of a claim as of March 1, 1913,[12] is an important consideration. If a taxpayer was entitled to property in 1912, but did not recover it until 1921, it cannot be held, and the Treasury does not hold, that he received any taxable income in 1921.

If he became entitled to property in 1914, but did not return it in that year because he did not know its actual value, it is not reasonable to claim that if he collected the claim or

[10] Reg. 45, Art. 1561, page 570.
[11] Bulletin 37-21-1813; O. D. 1028.
[12] For method of establishing value at March 1, 1913, see page 506.

received the property in 1921, the entire amount would be income in 1921. The courts might hold that the income arose in 1914 and give the taxpayer the privilege of filing an amended return for that year, but there is little in the trend of recent decisions to support such a belief. The courts are more likely to hold that when a taxpayer could have adopted the accrual basis of reporting, but did not do so, the election must stand.

As late as 1917 (see Chapter XXVI) the Treasury held that when a corporation was compelled, in 1916, to pay damages arising out of an infringement case and the period of infringement ended in 1912, no part of the sum paid was deductible as an expense in 1916, but that it should all be deducted (by amended returns) in the period prior to 1912.

Patent development costs.—The cost of developing a patent is of the same nature as carrying charges on real estate. One has the option of capitalizing the items or of charging them off as current expenses. Frequently it is difficult to determine which course should be pursued, even at the time. It may be obvious, after a period, that the experiments under way are not yielding satisfactory results. In such an event the cost is a clear expense. More often the result is doubtful, in which case it is permissible to elect whether to capitalize or to charge off the amount.

Conservative accounting methods call for charging off, but the owner may be penalized for so doing if current profits are not large. The subsequent sale of the patent for a considerable profit would result in a tax on the entire sale price, if the development costs had all been claimed as deductions and written off.

REGULATION. . . . . The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. . . . . (Art. 293.)

The foregoing regulation cannot always be applied to patent litigation. If the litigation does not clearly add to the

value of the patent, the expenses should be charged off as they are incurred. This view is adopted by the Treasury in the following:

EXPENSE OF PATENT LITIGATION NOT ADDED TO COST.—

RULING. The M Company expended a certain amount in litigation defending its right, title, and interest in a patent after the patent had been issued by the Government.

Held, that this amount may be deducted as an ordinary and necessary operating expense. The actual cost of the patent represented by various Government fees, cost of drawings, experimental models, attorney's fees, etc., paid before the patent was issued, will be returned to the company through annual depreciation deductions. . . . . (C. B. 2, page 105; A. R. R. 98.)

Method of valuing patents.—Owing to the great uncertainty which often exists regarding the commercial (that is, the market or income-producing) value of a patent, it is difficult to arrive at a fair taxable value when a sale or transfer is made for a consideration other than cash before the patent is fully developed.

In ascertaining the net taxable income of an inventor or owner to be assessed as of the year in which a transfer takes place, there should be taken into consideration the stage of the patent's commercial development, the degree of prosperity attained by the concern manufacturing it, and any other facts which serve to fix a fair value. Some of the information may appear to be of a later date, but it is valuable nevertheless.

Value of patents March 1, 1913.—In the 1917 law[13] patents were included among tangible assets. In the 1918 law[14] patents are included among intangible assets. Generally speaking the rules for valuing tangible and intangible property, heretofore discussed, govern the valuation of patents. The distinctive features which exist in regard to patents will now be discussed.

[13] Section 207 (a-3-a).
[14] Section 325 (a).

Values of patents must be established (a) to arrive at the basis for the computation of depreciation allowable as a deduction from gross income, and (b) for the purpose of reporting gains or losses resulting from their sale or disposition.

Regulation. A taxpayer disposing of patents or copyrights by sale should determine the profit or loss arising therefrom by computing the difference between the selling price and the cost. The taxable income in the case of patents or copyrights acquired prior to March 1, 1913, should be ascertained in accordance with the provisions of article 1561. The profit or loss thus ascertained should be increased or decreased, as the case may be, by the amounts deducted on account of depreciation of such patents or copyrights since February 28, 1913, or since the date of acquisition if subsequent thereto. (Art. 40.)

A patent is valuable for a limited period. It can never be treated as of permanent value *per se*. Rights and privileges permanent in their nature may develop from patents, but such rights should not be classified as patents. The monopoly granted by the government is for a specific period. Patents, therefore, come within the category of depreciable assets. At times it is difficult to distinguish between patents and goodwill.[15] Except for the year 1917 (when patents were tangibles), the only difference of importance between patents and goodwill is the element of depreciation.

Under the Treasury regulations a deduction for depreciation of patents is made at the election of the taxpayer. It is not obligatory. However, if depreciation has been taken the amounts so deducted must be considered when patents are sold or disposed of in the same manner as in the sale of tangible assets.[16]

Depreciation is such an important element that the correct valuation of patents as at March 1, 1913, may make a tremendous difference in the amount of taxes payable after January 1, 1917. Prior to that date the rate of tax was so low that it made little difference how much was claimed for de-

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[15] See article 843.
[16] Art. 843.

preciation of patents. Taxpayers who practically disregarded patent values and depreciation of patents prior to 1917, are not barred from reopening their accounts and tax returns and making proper adjustments.[17]

The mere failure to assert one's rights does not operate as a waiver.[18] The Commissioner is powerless to enforce any regulation or rule which limits the right of a taxpayer to correct his tax returns for previous years, except only in case of fraud.

It has not been, and cannot be, urged that the opening of tax returns arising from properly supported revaluations can be considered fraudulent.

There is, of course, one very practical objection to the reopening of tax returns for the years 1916 and prior. Section 252 of the 1921 law provides that no claims for refund will be allowed (including those under the 1909 and subsequent laws) unless the claim is filed within five years from the day when the return was due. If, however, invested capital under the 1917 or 1918 laws is decreased by the Commissioner as the result of insufficient deductions in prior years, which affect the returns of earlier years and so result in a credit for taxes in the earlier years, such amount may be credited or refunded regardless of the expiration of the five-year period.[19]

Returns for the calendar year 1916 were due March 1, 1917. If claims in respect thereof are not filed before March 1, 1922, the Commissioner will have no power to grant them.

To determine the actual value of patents at March 1, 1913, is in many cases a difficult task. Each case must be decided on its own merits. There existed at that date instances in which taxpayers had in the dim past merged patents and other in-

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[17] For table of terms of patents and copyrights in various countries, see C. B. 3, page 169.

[18] ". . . . Mere delay in asserting a right does not ipso facto bar its enforcement in equity, by the great weight of authority, unless the case is barred by the statute of limitations." (21 C. J. 221.)

[19] Law, section 252. See page 255.

tangible such as goodwill, in their accounts. In other instances a number of patents were acquired without a value being placed on each distinct patent. Intercompany book transactions also frequently tended to render the value of patents obscure. Numerous other complications exist. Nevertheless, in order that the taxpayers' interests may be protected and in order that the government may receive the proper amount of tax, patent values must be established. Where the amounts involved are large, it is a problem upon which sound judgment and experience should be employed.

Patents acquired subsequent to March 1, 1913, and later disposed of, do not differ from other assets in so far as the method of treatment for the purpose of determining gain or loss on the transaction is concerned.[20]

If patents were acquired solely for cash prior to March 1, 1913, and if the payments can be readily traced through the accounts, the tax laws presume that the cash payments represent the actual value of the patents at the time acquired. Unless the purchase was made immediately before March 1, 1913, the cash payment would not be an important factor in fixing the value as of that date.

If the consideration for the patents was stocks, bonds or notes which had a marketable value at the time of acquisition, it is presumed by the Treasury that the value of the patents was equal to the market value of the securities received therefor. If the securities were not marketable but were in the nature of investment securities having a fixed rate of return, their appraisal is usually a comparatively simple matter.

Cases have arisen in which the nominal value of stock issued for patents was considerably less than the known cash value. Such cases occur when, for some particular reason, it is desired to keep the capitalization of the purchasing corporation at a low figure. If the profit on sale be based on the nominal value of the stock, substantial injustice will be done to the taxpayer. The profit must be based on the real cash

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[20] See Chapter XVII.

value as of the time of acquisition, little or no attention being paid to the nominal value of stock issued for the patents. The foregoing applies particularly to common stock which usually receives the greatest benefit from a successful patent.

Actual value may be determined by earnings, past or prospective, which are attributable to the ownership of patents. If it can be shown that, after providing for a return on the net tangible assets, the excess is due to the ownership of patents, such excess earnings may be used in fixing the value of the patents.

Royalties paid by licensees is another factor to be considered in establishing patent valuations. Royalty agreements and schedules of receipts therefrom are valuable supporting evidence.

Furthermore, the value in many cases may be demonstrated by the opinions of those who, by reason of their technical knowledge and experience, are familiar with the value of the patents in question. This method of valuation meets with the approval of the Treasury.

> RULING. . . . . Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets: (C. B. 2, page 31; A. R. M. 34.)

In rare cases the value of patents can be established by sales of the particular patents at or about March 1, 1913. It is obvious that the value cannot be established by sales of similar property, because we are dealing with a monopoly. The law does not attempt to limit the 1913 value to its "market" price at that time. Section 202 (a) reads "the fair market price or value of such property." There is no possibility, in 99 out of 100 cases, of ascertaining a "market price" as at March 1, 1913, and it is useless to attempt it, because the law intends and authorizes taxpayers to determine the "value" of the patents as at that date.[21]

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[21] Reg. 45, Art. 1561. See page 570.

Regulation. No method of determining this value (March 1, 1913) can be stated by the Department which will adequately meet all circumstances. What that value was is a question of fact to be established by any evidence which will reasonably and adequately make it appear. (Reg. 33, paragraph 63.)

In general, the Commissioner is required to adopt the standards and definitions of value which have been approved by the United States Supreme Court. The Treasury, while not perhaps applying strict technical rules of evidence in matters of this kind, necessarily receives and gives the same weight to evidence admissible in court as would be accorded to such evidence by a court. It therefore becomes important to consider what attitude the courts may take with respect to the establishment of value of property having no technical market value. The courts not only permit, but require, that persons should be brought before the court who, from their technical experience and knowledge, are better qualified to form a judgment concerning the real value of such property than is the ordinary citizen; they require such person to detail his experience and means of knowledge to the jury, and then they permit him to express his opinion as to the actual value of the property in question, based upon his knowledge of that property in particular and upon his experience in general. The following decisions bear upon this subject:

Decisions. This question of damages, under the rule given in the statute, is always attended with difficulty and embarrassment both to the court and jury. There being no established patent or license fee in the case, in order to get a fair measure of damages, or even an approximation to it, general evidence must necessarily be resorted to. And what evidence could be more appropriate and pertinent than that of the utility and advantage of the invention over the old modes or devices that had been used for working out similar results? With a knowledge of these benefits to the persons who have used the invention, and the extent of the use by the infringer, a jury will be in possession of material and controlling facts that may enable them, in the exercise of a sound judgment, to ascertain the damages, or, in other words, the loss to the patentee or owner, by the piracy, instead of the purchase of the use of the invention. (*Suffolk Co. v. Hayden,* 3 Wall. 315-320.)

There remains for consideration but a single point—that there was admitted in evidence on the trial the opinions of witnesses as to the value of the land, which were not based upon the sale of the same or similar property, and were not, therefore, the opinions of persons competent to so testify. It appears that the land taken was a strip running through a mining claim, which had been patented and belonged to the defendants in error. . . . . And yet, uncertain and speculative as it is, such "prospect" has a market value; and the absence of certainty is not a matter of which the railroad company can take advantage, when it seeks to enforce a sale. Contiguous to a valuable mine, with indications that the vein within such mine extends into this claim, the railroad company may not plead the uncertainty in respect to such extension as a ground for refusing to pay the full value which it has acquired in the market by reason of its surroundings and possibilities. In respect to such value, the opinions of witnesses familiar with the territory and its surroundings are competent. At best, evidence of value is largely a matter of opinion, especially as to real estate. True, in large cities, where articles of personal property are subject to frequent sales, and where market quotations are daily published, the value of such personal property can ordinarily be determined with accuracy; but even there, where real estate in lots is frequently sold, where prices are generally known, where the possibility of rental and other circumstances affecting values are readily ascertainable, common experience discloses that witnesses the most competent often widely differ as to the value of any particular lot; and there is no fixed or certain standard by which the real value can be ascertained. The jury is compelled to reach its conclusion by comparison of various estimates. Much more so is this true when the effort is to ascertain the value of real estate in the country, where sales are few, and where the elements which enter into and determine the value are so varied in character. And this uncertainty increases as we go out into the newer portions of our land, where settlements are recent and values formative and speculative. Here, as elsewhere, we are driven to ask the opinions of those having superior knowledge in respect thereto. It is not questioned by the counsel for plaintiff in error that the general rule is that value may be proved by the opinion of any witness who possesses sufficient knowledge on the subject; but their contention is, that the witnesses permitted to testify had no such sufficient knowledge. It is difficult to lay down any exact rule in respect to the amount of knowledge a witness must possess; and the determination of this matter rests largely in the discretion of the trial judge. Stillwell Manufacturing Co. v. Phelps, 130 U. S., 520; Lawrence v. Boston, 119 Mass., 126; Chandler v. Jamaica Pond Aqueduct Corporation, 125 Mass., 544. The witnesses whose testimony is complained of, all testified that they knew the land and its

surroundings; and many of them that they had dealt in mining claims situated in the district, and had opinions as to the value of the property. It is true, some of them did not claim to be familiar with sales of other property in the immediate vicinity; and the want of that means of knowledge is the specific objection made in the Supreme Court of the Territory to the competency of those witnesses. But the possession of that means of knowledge is not essential. It has often been held that farmers living in the vicinity of a farm whose value is in question, may testify as to its value although no sales have been made to their knowledge of that or similar property. Indeed, if the rule were as stringent as contended, no value could be established in a community until there had been sales of the property in question, or similar property. After a witness has testified that he knows the property and its value, he may be called upon to state such value. The means and extent of his information, and therefore the worth of his opinion, may be developed at length on cross-examination. And it is fully open to the adverse party, if not satisfied with the values thus given, to call witnesses in the extent of whose knowledge and the weight of whose opinions it has confidence. (*Montana Railway Co. v. Warren*, 137 U. S. 348, 352, 353, 354.)

Inventions are of all sorts, and it is very difficult for a jury to estimate the value of the use of any invention either before or after the issue of letters patent. We are of opinion that, in the discretion of the court, a witness with the qualifications shown in this case might be permitted to give an opinion of the value of the use of inventions relating to stock and cattle cars. Sturgis v. Knapp, 33 Vt., 486, 531; Butler v. Mehrling, 15 Ill., 488; Brady v. Brady, 8 Allen, 101; Vandine v. Burpee, 13 Metc. (Mass.), 288; Beale v. City of Boston, 166 Mass., 53, 56, 43 N. E., 1029. (*Burton v. Burton Stock Car Co.*, 50 *N. E. Rep.* 1029, 1031.)

Where there is no evidence to show that any license fee has ever been paid or demanded, the jury, in estimating the damages, should consider the utility and advantage to the defendant of the use of the patented device, as compared with any other means of obtaining similar results whose use was open to it, and may compare the cost of using the one to the cost and saving in the use of the other. (Syllabus, *Brickill et al. v. Mayor, etc., of Baltimore*, 60 Fed. 98, 8 C. C. A. 500.)

In the last case cited, the Circuit Court of Appeals for the Fourth Circuit approved the following charge to the jury:

This is an action at law for the damages sustained by the plaintiffs for the alleged infringement, and in such actions, when there has been proved an established royalty or license fee, which has

been customarily paid to the owner of the patent by those who desired to use it, such regular price for a license is the primary and true criterion of the plaintiff's damage; but in this case there is no evidence of any license fee ever having been demanded or paid by any one; and so, if you find in favor of the plaintiffs, you should consider the utility and advantage to the defendant of the use of the patented device, as compared to any other means of obtaining similar results which were open to the defendant to use, and you may consider the cost of using one as compared with the cost and savings to the defendant of using the other; and from these data, if proven to you, you should ascertain, in the exercise of a sound judgment, what would be a fair compensation to the plaintiffs for the damage which they have sustained by reason of the defendant having infringed, instead of having purchased the right to use, the invention.

RULING. The Committee has considered the question of providing some practical formula for determining value as of March 1, 1913, or of any other date, which might be considered as applying to intangible assets, but finds itself unable to lay down any specific rule of guidance for determining the value of intangibles which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-mark, trade brands, etc. . . . . (C. B. 2, page 31; A. R. M. 34.)

Also see cases cited in discussion regarding fair value of services, page 871.

Patents not issued March 1, 1913, may be valued.—The Treasury very properly permits applications for patents to rank with those issued in ascertaining values as of March 1, 1913.[22] This is on the theory that there is an assignable property right in an application for a patent. Obviously, if no patent is subsequently issued there can be no value at March 1, 1913.

The method of depreciation, when a patent was not issued until after March 1, 1913, necessarily differs from that applicable to patents issued prior to March 1, 1913. For a discussion of this point, see Chapter XXXI.

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[22] C. B. 3, page 342; A. R. R. 328.

Royalties subject to depreciation charges.—The following ruling explains the extent to which royalties subject to depreciation charges are taxable.[23]

RULING. A invented certain apparatus and secured United States patents thereon. The patents were assigned to a foreign corporation under an agreement by which he retained 40 per cent interest in profits therefrom. Legal title to the patents passed to the company subject to the agreement mentioned. A's interest was recognized by the company and by the United States licensees under the patents. The committee is of the opinion that the agreement should be recognized as giving A a depreciable interest in the patents.

The value of each patent as at March 1, 1913, should be segregated and the depreciation allowable thereon determined on the basis of its own life instead of using as a basis the average life of all the patents and the value of all the patents in bulk. Of the total depreciation allowable for any year, 60 per cent is deductible in the return of the company and 40 per cent in A's return. (C. B. 2, page 142; A. R. M. 35.)

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[23] See Chapter XXXI for a full discussion of the depreciation of patents.

CHAPTER XIX

INCOME FROM INTEREST—GENERAL

All interest, except on state, municipal and certain United States securities, is to be included in gross income, whether on notes, bank deposits, securities, bonds, mortgages or deeds of trust or other similar obligations of domestic corporations and insurance companies, bonds issued in foreign countries or upon foreign mortgages or like obligations (not payable in the United States).

Interest on tax-exempt securities is not to be reported as a part of gross income. The statement showing the number and amount of such securities and the income therefrom which was required to be submitted with the annual income tax return[1] under the 1918 law, is not required under the 1921 law.

Subject to the exceptions stated, not only is all interest received by residents and domestic corporations taxable, but interest received by non-resident aliens and foreign corporations from sources within this country[2] is also taxable—a fact which raises an interesting question of international double taxation.[3]

The law and procedure regarding interest derived from United States obligations, including farm loans, will be found in the following chapter. Interest from all other sources will be discussed in this chapter.

Interest subject to tax.—

LAW. Section 213. **That for the purposes of this title . . . . the term "gross income"—**

(a) Includes gains, profits, and income derived from . . . . interest . . . .

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[1] Prior to 1918, interest which was entirely exempt from taxation did not have to be reported at all.

[2] As defined in section 217 (a-1) of the 1921 law. See Chapter XXXVI.

[3] For discussion of the principles involved in the taxation of non-resident aliens, see Chapter XXXVI.

In order to exclude all exempt interest from taxation, taxpayers, particularly banks and other financial institutions, should keep separate ledger accounts for interest from various sources.

Interest accrued but not collected.—So far as possible taxpayers are expected to keep their accounts on an accrual basis and return as income all interest which accrues to them.

REGULATION. When interest coupons have matured, and are payable, but have not been cashed, such interest payment, though not collected when due and payable, is nevertheless available to the taxpayer and should therefore be included in his gross income for the year during which the coupons matured. This is true if the coupons are exchanged for other property instead of eventualyl being cashed. Defaulted coupons are income for the year in which paid. . . . . (Art. 53; Reg. 45, Art. 54.)

Unless the foregoing regulation is intended to refer only to cases where payment can be secured upon presentation of the coupons, it is too optimistic. It states without reservation that when interest is due it "is nevertheless available to the taxpayer."

Owners of public utility bonds which have been made worthless, or nearly so, by the hostile action of municipal authorities, as in New York City, or by confiscatory legislation in other places, should not accrue the interest until there is a reasonable chance of collecting it. Of course, if the taxpayer could collect, but does not, there is no excuse for not reporting the amount accrued.

Accrued interest returned as income which is not subsequently collected.—Taxpayers reporting upon the accrual basis should report as taxable income accruals from real estate mortgages, loans and other obligations when there is a reasonable expectation that such interest will be received in due course. In cases where it develops that the debtor is unable to pay the interest previously entered as income, this interest should be charged off on the taxpayer's books as soon as it

is known to be worthless, and proper credit should be taken therefor in making the next succeeding income tax return.[4]

Interest accrued prior to March 1, 1913, not taxable.[5]—The regulations provide that interest which fell due on or before March 1, 1913, and was subsequently collected, is not taxable.[6]

REGULATION. Any claim existing unconditionally on March 1, 1913, whether presently payable or not and held by a taxpayer prior to March 1, 1913, whether evidenced by writing or not, and all interest which had accrued thereon before that date, do not constitute taxable income, although actually recovered or received subsequent to such date. Interest accruing on or after that date is taxable income. Where an interest-bearing claim held on February 28, 1913, is paid in whole or in part after that date, any gain derived from the payment of the claim is taxable. The amount of such gain is the excess of the proceeds of the claim (both principal and interest) exclusive of any interest accrued since February 28, 1913, already returned as income, over the cost thereof (both principal and interest then accrued). However, the gain to be included in gross income where the fair market value of the claim as of March 1, 1913, is greater than the cost thereof, is the excess of the amount received over such value. No gain results where the amount received from the claim is more than the cost thereof but less than its fair market value as of March 1, 1913. . . . . (Art. 90, Reg. 45, Art. 87.)

Interest accrued prior to January 1, 1909, not taxable.—

RULING. Interest which accrued prior to 1909, and was paid in 1911, was not income within the provisions of the excise tax law of 1909.[7] (C. B. 3, page 243; T. D. 3048.)

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[4] **[Former Procedure]** Where interest on loans made by a parent corporation to its subsidiary accrued from year to year, but was not paid, the amount thus accrued during a taxable year cannot be considered income to the parent company within the meaning of the Act of August 5, 1909. (T. D. 3133, dated February 25, 1921.)

[5] **[Former Procedure]** It was held that interest which became due and payable after March 1, 1913, was all taxable even though part accrued prior to March 1, 1913. The instance mentioned concerned an interest coupon due April 1, 1913, covering six months' interest to that date. There was an attempt to tax five months' interest which accrued prior to March 1, 1913. The proposed assessment could not be supported by the law and was not insisted upon.

[6] See Chapter XXII.

[7] *Northern Pacific Ry. v. Lynch, Collector* (U. S. D. C. Minn., March 22, 1920, not reported; see T. D. 3048); also see *Walker v. Gulf & Interstate Ry. Co. of Texas,* 269 Fed. 885 (quoted in T. D. 3133).

The Treasury had imposed a tax on interest accrued prior to January 1, 1909, collected in 1911, although the decisions of the courts should have been sufficient notice to the Treasury that its position was untenable. The case was defended by the government when it was heard, March 22, 1920, but the court directed that the tax be refunded, with interest from the date of its collection.

Interest on Obligations of States and Political Subdivisions

It will be recalled that the law exempts interest upon "the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia." [Section 213 (b-4)][8]

Definition of a political subdivision.—The interpretation of the phrase "interest upon the obligations of a state . . . . or any political subdivision thereof" has raised the question as to whether certain special assessment districts are political subdivisions. The present regulations, in addition to defining obligations of a state, give a broad, inclusive definition of a political subdivision which results in the exemption of interest on the securities of special assessment districts (drainage, irrigation, school, etc).[9]

Irrigation districts.—

Ruling. In some of the Western States irrigation districts are created by an election duly called for the purpose. The county assessor of the county in which the land benefited is located assesses all such property on the assessment rolls of the county and a tax is levied and collected in the same manner as other taxes are levied and collected.

Held, the district is a political subdivision of the State and interest on its bonds is exempt from income tax. (C. B. 2, page 93; O. D. 544.)

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[8] For text of section 213 (b-4) and Art. 74, see page 359.

[9] *Infra* (Art. 74).

[Former Procedure] For conflicting regulations prior to 1919, see *Income Tax Procedure,* 1920, page 403.

Mortgage indebtedness assumed by municipality.—

REGULATION. . . . . The purchase by a State of property subject to a mortgage executed to secure an issue of bonds does not render the bonds obligations of the State, and the interest upon them does not become exempt from taxation, whether or not the State assumes the payment of the bonds. (Art. 74.)

Land sold for non-payment of taxes.—

RULING. Certificates of sale issued by the county treasurers of counties of Wisconsin to purchasers of land sold for the nonpayment of taxes are not obligations of political subdivisions of the State of Wisconsin. Such certificates do not place any obligation upon the county to pay any sum of money to such purchasers. The statute provides that the owner or occupant of such land may at any time within three years from the date of the certificate redeem the same or any part thereof by paying to the county treasurer for the use of the purchaser the amount for which such land was sold, together with subsequent charges thereon authorized by law, but does not provide that the county is either directly or indirectly liable for the redemption thereof.

It is held, therefore, that the interest on the tax certificates issued by county treasurers of counties of Wisconsin is not exempt from tax. (B. 48-21-1944; O. D. 1114.)

Interest on awards by state or municipality.—When a state or city takes property under the power of eminent domain, or when other awards of a state or city are paid with interest, the question arises as to whether or not interest on an award is equivalent to interest on an obligation and therefore is exempt from federal taxes.

The liability of a city to pay for property taken under the power of eminent domain is certainly an obligation. State constitutions provide that private property shall not be taken for public use except upon just compensation paid or secured. A city is allowed to give its own bond and under the obligation of this bond it is compelled to pay just compensation. Such just compensation is due as of the date of the taking, and when not paid immediately the citizen is placed in the same position by the payment of interest as such, or by the payment of an additional amount, which in some cases is

spoken of as "damages for detention" not exceeding legal interest, but it is in substance interest. It is, of course, of importance to the recipient that any part of the award which actually is tax-exempt interest should be properly designated.

RULINGS. Bonds were issued by a municipality of Wisconsin, in accordance with the general city charter law of that State, to cover deferred installments of assessments against real estate for the cost of certain public improvements. Each bond was a lien upon all the property benefited to the extent of unpaid assessments and interest thereon. The bonds contained recitals that they were chargeable only to the particular property described therein, and that they should in no event constitute a general city liability.

Notwithstanding the bonds were not a general liability of the city, they were issued by the city for public purposes and are obligations of a political subdivision of a State within the meaning of section 213(b) 4 of the Revenue Act of 1918, and the interest upon such bonds is accordingly exempt from tax. (C. B. 2, page 93; O. D. 447.)

Interest received by a contractor on paving assessments issued to him by a municipality in payment for work under the provisions of the statutes of a certain State is exempt income under section 213 (b) 4 of the Revenue Act of 1918. . . . . (B. 34-21-1778; O. D. 999.)

Interest on bonds issued by agricultural and horticultural societies under authority of section 7852, compiled laws of Michigan, is not exempt from tax under section 213 (b) 4 of the Revenue Act of 1918. (B. 31-21-1751; O. D. 983.)

Sale of municipal bonds issued at a discount.—

RULING. The M bank purchased certain 10 year 4½ per cent municipal bonds at 96.10 which had been originally issued and sold by the municipality at 94.50. The question is presented as to whether in case the bank sells the bonds before maturity at 98, the profit realized will be exempt in its hands.

Held, that inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at the specified rate or in the form of realized discount) any person selling municipal bonds for an amount in excess of the cost of the bonds to him realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount.

If, therefore, the bank sells at $98 the municipal bonds issued at

$94.50 and purchased by it at $96.10, it will derive a taxable profit of $1.90 on each bond sold. If, however, it holds the bonds to maturity and receives $100 the difference between the purchase price of the bonds and the amount received, or $3.90, will represent exempt income to it. (C. B. 4, page 31; O. D. 762.)

Interest from Miscellaneous Sources

The law and the regulations do not enumerate all the sources from which taxable interest may be derived, but as with other items of income, the question of taxability depends on whether or not the amount received or accrued is in fact income.

Interest on bank deposits.[10]—

REGULATION. . . . . Interest credited on savings bank deposits, even though the bank nominally have a rule, seldom or never enforced, that it may require so many days' notice in advance of cashing depositors' checks, is income to the depositor when credited. . . . . (Reg. 45, Art. 54.)

As to non-resident aliens see Chapter XXXVI.

Interest on loans to Liberty bond subscribers.—

RULING. Interest received by a bank on loans to subscribers for Liberty bonds is *not* interest received on obligations of the United States, and is therefore subject to tax. (C. B. 1, page 67; O. D. 16.)

Interest on Food Administration Grain Corporation notes.—

RULING. Interest on Food Administration Grain Corporation notes is not exempt from income and excess profits taxes. (Telegram

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[10] **[Former Procedure]**

REGULATION. "Interest on bank deposits or on certificates of deposit, whether paid or accrued and unpaid, must be included in the annual income return of the person entitled to receive such interest, whether on open account or on the certificate of deposit." (Reg. 33, 1914, Art. 67.)

This regulation ignored the "cash" basis, and required a return on the accrual basis. If the taxpayer did not receive notice of the interest until after his cash account for the year was closed, and if he were reporting upon a cash as distinguished from an accrual basis, he would, however, not have been required to *include* the interest until the following year.

to The Corporation Trust Company, signed by Commissioner Roper, April 13, 1919.)

Interest charged to construction.—

RULING. No taxable income accrues to a public utility corporation from a mere book entry charging construction account and crediting income account due to charging interest on the company's own funds used temporarily for construction purposes, as permitted under the Interstate Commerce Commission's classification; neither will the company be allowed to include in its assets such amount of interest charged to capital account for the purpose of determining invested capital. (C. B. 1, page 212; O. D. 246.)

By O. D. 1061 (B. 41-21-1862) this ruling was extended to apply to the Revenue Acts of 1916 and 1917.

Income from bonds paid at maturity or before.—When bonds are purchased at a discount from their face value or when they are purchased at par and paid off at a premium, the excess received above cost or value March 1, 1913, (and interest periodically collected) is taxable income.

If a taxpayer keeps his accounts on an accrual basis it would be good accounting practice to enter annually as income a proportional part of the difference between cost and par, and return such accruals for income tax purposes. When the bonds are paid at maturity or called, the amount to be returned will be only the difference between cost, or value March 1, 1913, plus the amounts previously returned (except interest actually collected) and the amount received.

When the amount received is less than cost or value March 1, 1913, plus the amounts returned as income, the difference is an allowable deduction as a loss. (See Chapter XXIX.)

The rule, in effect, is disapproved by the Treasury in the following ruling.

RULING. Interest received or accrued on bonds purchased at a premium, according to the method employed in keeping books, represents income for the year in which received or accrued at the

rate carried by the bonds and not at the rate which would be realized after amortizing the premium.[11] (C. B. 3, page 89; O. D. 622.)

It is not believed, however, that a taxpayer who keeps his accounts according to well-recognized accounting principles would be required to make any change therein in order to conform to the foregoing ruling, which conflicts with good practice.

The author consistently has held that discount on bonds or like securities is, in effect, an increased rate of interest. The Treasury, with equal consistency, holds that the discount is a profit to the recipient and a loss to the payer.[12]

It may be expected that non-interest bearing notes and bonds will become popular. Taxpayers in receipt of large incomes loaning money for more than two years, will be able to buy the obligations at a discount and report their gross returns thereon as capital gains.

Income from redemption of bonds—amortization of premium.—The following regulation summarizes the cases in which income is deemed to arise upon the redemption by a corporation of its own bonds or from the amortization of the premium on its bonds sold above par.

Regulation. (1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (*a*) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value

[11] See Chapter XXVII.

[12] *Income Tax Procedure*, 1921, pages 510, 734; *Auditing, Theory and Practice*, by R. H. Montgomery (1921 edition), page 531.

plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.

(3) (*a*) If bonds are issued by a corporation at a discount, [and] . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year. (Art. 545. Reg. 45, Art. 544.)

The subject of deductible loss because of the purchase and retirement by a corporation of its bonds is discussed in Chapter XXIX.

Interest received by stock-brokers and others.—Interest charged by stock-brokers and others, who in the ordinary course of business make regular interest entries against customers' accounts, should be reported in income tax returns at the gross amount so accrued or collected, and not at the net amount ascertained by deducting interest paid. Under the 1917 and prior laws, reporting the net amount was held to be illegal.[13]

Sinking fund increment.—Under the earlier laws the question arose as to whether or not interest on a corporation's own bonds held in its own sinking fund should be reported as income. Under the 1918 and 1921 laws, it is immaterial how the interest is reported. The limitation on the interest deduction no longer exists.[14]

REGULATION. If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust, or sets aside certain amounts in a sinking fund under the control of a trustee, who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation

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[13] This point was decided in the case of *Altheimer & Rawlings Investment Co. v. Allen, Collector* (248 Fed. 688, 160 C. C. A. 588, 248 U. S. 578; certiorari denied, 63 L. E. 430, 39 S. Ct. 20.

[14] **[Former Procedure]** For criticisms of regulations under former laws, see *Income Tax Procedure*, 1920, page 407.

and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its annual return. The trustee, however, is not taxable as such on account of the property or fund so held. (Art. 542, Reg. 45, Art. 541.)

Income from building and loan associations.[15]—A new provision has been written into the law exempting dividends or interest from building and loan associations up to an amount of $300 per annum, effective for the years 1922-1926, inclusive.

LAW. Section 213. . . . . (b) . . . . (10) **So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;** . . . .

Although a literal interpretation of this provision[16] would indicate an exemption aggregating $300 over the period, January 1, 1922, to December 31, 1926, the author is of the opinion that the intention of Congress was to exempt from taxation interest from building and loan associations up to a maximum of $300 each year. The author's interpretation is confirmed by a study of the original House provision and of the conferees' report. The House bill contained the following:

So much of the amount received by an individual as dividends or interest from Domestic Building & Loan Associations, operated exclusively for the purpose of making loans to members, as does not exceed $500.

The conference report makes the following explanation of the change made in the final act:

Amendment No. 152: The House bill provides that individuals should not be required to include in their gross income so much of the

[15] **[Former Procedure]** For prior regulations see *Income Tax Procedure*, 1921, pages 511-512.

[16] Such an interpretation has not been made by the Treasury in Art. 89 (2). This regulation accords with the intent of Congress, even if the draftsmen of the law failed to express the thought accurately.

amount received by them as dividends or interest from Domestic Building & Loan Associations operated exclusively for the purpose of making loans to members, as does not exceed $500. The Senate amendment strikes out the provision of the House bill. The House recedes with an amendment permitting the exclusion from gross income of an amount of such dividends or interest not in excess of $300 and providing that this exclusion from gross income shall only be in effect from January 1, 1922, until January 1, 1927.

The author's contention is confirmed by the following extracts from the *Congressional Record*, 1921.

Congressman Treadway:

Perhaps Mr. Average Man may become fairly well to do and wishes to save in expectation of owning his own home. He has the opportunity under the new bill of investing his savings in a mutual building and loan association and up to $500 his income from this source will be exempted—another evidence of the interest this bill is showing in the home life of the man of moderate means. (Page 5624.)

Congressman Longworth:

This bill carries this provision: We make the first $500 of income received from capital invested in the stock of building associations exempt from any tax at all. We put it on the same basis to the extent of $500 as all other nontaxable investments. There is no question now but that the stock in a building association amounting to $10,000 will be a reasonably attractive investment and will result in a great increase of capital available for the building of small homes throughout the country. This is a small thing on paper, perhaps, but I believe it is a big thing in the interest of the plain people of this country, and Democrats propose to vote against it. (Page 5704.)

The conferees intended merely to reduce the exemption of $500 per annum to $300 per annum, not to $300 spread over five years, otherwise the reference to $10,000 of principal would have been absurd.

The foregoing interpretation has been accepted by the Treasury, as indicated in in the following:

REGULATION. . . . . The following additional exclusions from gross income . . . . are allowed . . . .

(2) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations operated exclusively for the purpose of making loans to members as does not exceed $300 per year; . . . . (Art. 89.)

AMOUNT TO BE REPORTED.—

RULING. . . . . An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. Where the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share. (Art. 53. Reg. 45, Art. 54.)

RULING. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. Therefore an amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit and should be so reported by the shareholder.

In cases, however, where the amount paid in by the shareholder and the accumulative profits do not become available to the shareholder until the maturity of a share, the proceeds of any share subscribed for subsequent to March 1, 1913, in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share.

If the subscription was made prior to March 1, 1913, and under the rules of the association the share subscribed for had a cash surrender value on March 1, 1913, and any year thereafter in excess of the amount paid in by the shareholder, the determination of any profit realized at the time of cash surrender or for the year of the maturity of the share will be based on the proceeds in excess of the cash surrender value as of March 1, 1913, plus the aggregate amount paid in subsequent thereto. (C. B. 2, page 87; O. D. 446.)

Stockholders in building and loan associations may desire to set up on their books annually the interest or earnings allotted to their particular shares. In such cases the only income to report in the year of maturity would be the difference between income already taxed and final profit received.

Shares in many building and loan associations are not of the same nature as shares in corporations. No dividends are declared, but earnings are ascertained and are fully apportioned *pro rata* to the outstanding stock. So far as the books of the associations are concerned, an actual distribution is made and no surplus account is carried.

The accruing annual income from building and loan association shares and from life insurance policies is in the nature

of interest earnings, as the funds are invested almost entirely in bonds and mortgages. They are formed on the mutual plan so that each stockholder or policyholder is in effect realizing annually his pro rata share of the entire net income.

If under any tax law the net income of the association or company should be taxed, the proportion accruing to its members would be free from the normal tax.

Interest on securities acquired between interest dates.—When securities are purchased between interest dates and the buyer pays to the seller an amount equal to the accrued interest between the last interest date and the date of sale, each should enter as income the portion of the interest assignable to the period during which he owned the security.

RULING. Interest accrued on bonds and other interest-bearing obligations sold between interest dates is income as such to the vendor when the agreement of sale specifies a division between the price of the obligation and the accrued interest.

The vendee of such securities may exclude from interest income a sum equal to the amounts advanced by him to the vendor on account of accrued interest.

Capital gain or loss resulting from a sale of interest-bearing obligations sold between dates at a stipulated price plus accrued interest is computed upon a basis of capital investment, and without regard to amounts paid or received on account of accrued interest.

The burden is on the taxpayer to show what part of moneys paid or received by him on account of a transaction involving the sale or purchase between interest dates of interest-bearing obligations should be allocated to capital investment and what part to accrued interest. In the absence of such showing the construction most favorable to the Government should be adopted. (C. B. 3, page 90; Sol. Op. 46.)

Interest received by legatee.—T. D. 2570 (November 6, 1917) holds that:

RULING. A legatee is required to return as income the full amount of interest received by him on a bond, notwithstanding the fact that a part of the first coupon, payable after he had received it, had been added to the bond and included in the gross estate of the decedent, thereby becoming subject to the estate tax law.

If the estate was assessed for the income tax on the accrued

interest to the date of the death of the decedent the legatee should not pay again on the same amount, since property received by legatees is capital and includes accrued interest. The 1917 regulation is unsound and probably will not now be enforced.

Coupons used as purchase price for other securities.—

REGULATION. Coupons from bonds for interest thereon, exchanged for other bonds, are held to be the equivalent of payment of the interest coupons and purchase of the new bonds with the cash. The amount of the coupons is to be accounted for as income for the calendar year in which the exchange is made. (Reg. 33, 1918, Art. 4.)

If coupons and new securities were exchanged "par for par," the interest represented by the coupons would be reduced by an amount equal to the difference between the par value of the new securities and their fair market value.

Income from life insurance policies.—The law exempts from income taxation[17] the entire proceeds of life insurance policies (see page 352) upon the death of the assured when paid to individual beneficiaries, to the estate of the assured or to a corporation beneficiary.[18] The total amount paid in premi-

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[17] The taxability of the proceeds of life insurance under the estate tax law is discussed in Chapter XL.

[18] **[Former Procedure]**

1913 LAW. Section IIA. Subdivision 2 B. ". . . . the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income."

Under the 1916 and 1917 laws (section 4) insurance payable to the estate of the insured was taxable.

REGULATION. "Proceeds of life insurance policies payable to the estate of a decedent, when received by an executor or administrator, are, in the amount of which such proceeds exceed the premium or premiums paid by the decedent, income of the estate to be accounted for by the executor or administrator under the provisions of section 2 (b), act of September 8, 1916." (Reg. 33, 1918, Art. 29.)

This regulation was based on section 2 (b) of the law. Until the question is judicially settled an estate is entitled to claim that a policy should be valued as of March 1, 1913, as a basis for taxation under the 1916 or 1917 law. Under the 1918 law insurance paid to a corporation beneficiary was taxable.

ums may be less than the amount eventually received from the proceeds of a policy, but the difference is not treated as taxable income. The law[19] expressly limits the exemption. When there is a return of principal to the assured during his life, that part, if any, of such return which is in excess of the premiums paid is taxable. The basis of this provision is that the amount received in excess of the premiums paid represents interest on the premiums.

The purpose of the law in mentioning the exemption from taxation of premiums returned or the equivalent of premiums returned evidently was to leave no doubt about the matter. When premiums are paid they do not in this country[20] constitute an allowable deduction, but are treated as capital payments. Therefore the return of all or any part of such capital could not be taxed under an income tax law. However, the law covers the point, even if unnecessarily, and there can be no controversy about it. If the assured receives at the maturity of a policy on the endowment plan, or from its cancellation, any amount in excess of premiums paid, such receipts are taxable income and must be returned.[21] As provided in article 47, any dividends received would be subject only to the surtaxes.

In view of the uncertainty of such income it would hardly be practicable to accrue it annually on the books of the assured. This means that the entire excess above premiums paid must be included in the returns for the year of its receipt.

REGULATIONS. . . . . In the case of an insurance policy its surrender value as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition of such property. . . . . (Art. 90.)

. . . . Where an insured receives under life insurance, endowment, or annuity contracts sums in excess of the premiums paid therefor, such excess is income for the year of its receipt. . . . . Distributions on paid-up policies which are made out of earnings of

[19] Section 213 (b-2).
[20] For British practice, see Chapter XXVI.
[21] See "Paid-up Policies," Chapter XXVI.

the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. (Art. 47.)

CASH SURRENDER VALUE OF POLICY AT MARCH 1, 1913.—

RULING. The basis for ascertaining the taxable income resulting from the disposition of a life insurance policy acquired prior to March 1, 1913, where the insured transfers the policy to some one other than the insurance company, which wrote the policy, is the cash surrender value of the policy as at March 1, 1913. However, if the insured surrenders his policy and all his rights thereunder to the insurance company, which wrote the policy, the aggregate amount of the premiums paid during the period the policy was held, or the cash surrender value of the policy as at March 1, 1913, whichever is greater in amount, is to be taken as the basis in computing the taxable income derived by the insured. (C. B. 2, page 77; O. D. 379.)

Annuities.—

REGULATION. Annuities paid by religious, charitable, and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract. An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources. The devisee is not required to return as taxable income the amount of rent paid to the annuitant, and he is not entitled to deduct from his taxable income any sums paid to the annuitant. . . . . (Art. 47.)

Many annuities are gifts. In such cases this ruling strictly interpreted would not apply. The amounts received by the beneficiary would be taxable income only to the extent of the excess of the aggregate receipts above the capital value of the annuity at the date of the gift.

RULING. An individual who receives income from an annuity which has been purchased for his benefit by another person is not liable for tax thereon until the payments received under the terms of the annuity have equaled the amount paid or set aside to purchase or establish same. (C. B. 2, page 76; O. D. 170.)

Deduction in case of tax-free covenant bonds.—It has been the custom for certain corporations to issue bonds containing

a covenant binding the corporation to pay the interest free of all taxes which it may be required to withhold at the source.[22]

TAX PAID BY OBLIGOR NOT INCOME TO OBLIGEE.—The 1921 law provides that the recipient of income from securities containing a tax-free covenant does not include in gross income the tax of 2 per cent paid by the obligor (payer of the income).

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[22] **[Former Procedure]** The 1913 law, by establishing the system of collection at the source, threw upon such corporations the burden of paying the normal tax applicable to the interest payable to their bondholders. The rate under this law was 1 per cent. The requirement was continued under the 1916 law, which raised the rate to 2 per cent.

1916 LAW. Section 5. " . . . . (c) For the purpose of the normal tax only, the income embraced in a personal return shall be credited with . . . . the amount of income, the normal tax upon which has been paid or withheld for payment at the source of the income under the provisions of this title."

In 1917, when the system of collection at source was almost completely abandoned and the rates of the normal tax were increased to 4 per cent on individuals and 6 per cent on corporations, collection at the source was retained to the extent of 2 per cent only in the case of these tax-free covenant bonds. In the 1918 law the same provision is made.

1918 LAW. Section 221. " . . . . (d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return."

Under the 1918 law, the recipient of income from securities having a tax-free covenant was required to include in gross income not only the income actually received, but also the tax paid by the obligor, which the Treasury held was constructively received. Ever since the issue of the second edition of Reg. 45 (April, 1919), the author has contended that the tax of 2 per cent paid by the obligor was not income of the obligee. That the author was justified in his criticism of the rulings and regulations is proven by the new provision in the 1921 law. For a full discussion see *Income Tax Procedure*, 1921, pages 516-522.

The Treasury's position has been upheld in a recent decision by the United States District Court for the Eastern District of Pennsylvania (*Massey v. Lederer, Collector*). In that case, however, the court did not have presented to it and did not consider what the author considers to be the chief factor, viz., the attempt of Congress to make the deduction effective by permitting it to be deducted from the amount of tax payable. Such action precludes the inference that it should be dealt with as constructive income.

LAW. Section 234. **(a) . . . . (3) . . . . In the case of obligors specified in sub-division (b) of section 221[23] no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed, nor shall such tax be included in the gross income of the obligee. . . . .**

This provision is effective January 1, 1921; therefore, no tax should be included by the recipient in 1921 income. Section 221 (d) still permits the tax paid by the obligor to be deducted from the tax due by the recipient as shown by his return.[24]

Interest from foreign subsidiaries.—

RULING. A domestic corporation owning a majority of the stock of foreign corporations should include in its income tax return any amounts of interest debited to its foreign subsidiaries, but it may claim as a deduction any amount of interest credited to such subsidiaries. . . . . (C. B. 1, page 239; O. D. 330.)

[23] See page 323.
[24] See page 333.

CHAPTER XX

INCOME FROM INTEREST ON OBLIGATIONS OF THE UNITED STATES

(INCLUDING INTEREST ON BONDS ISSUED UNDER THE FEDERAL FARM LOAN ACT AND ON BONDS OF THE WAR FINANCE CORPORATION)

The obligations of the United States, interest upon which is subject to special treatment in tax returns, are so many and so large in amount that it is deemed advisable to devote an entire chapter to the income from such obligations.

At the outset it should be noted that there are two broad statements which can be made in reference to interest received by all taxpayers (except non-resident aliens and foreign corporations, partnerships and associations not engaged in business in the United States)[1] upon obligations of the United States and obligations issued under the Federal Farm Loan Act of July 17, 1916, and the War Finance Corporation Act, approved April 5, 1918.

1. No part of such interest is subject to normal income tax upon individuals or income tax upon corporations.

2. Such interest is subject to surtaxes and excess profits and war profits taxes[2] only in the case of obligations issued after September 1, 1917, and as to these, only so far as such interest is not exempt under provisions of the several Liberty bond acts and other acts under which these obligations are issued.

By authority of one of these acts the 3¾ per cent Victory notes, although issued after September 1, 1917, are not subject to any surtax, excess profits or war profits taxes. All the Farm Loan bonds are wholly tax-exempt.

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[1] See page 692.

[2] All Liberty bonds are subject to the estate tax. See Chapter XL.

Interest which is wholly exempt from tax is excluded from "gross income" as defined in the 1921 law. If the income of a taxpayer is wholly from exempt sources, or if his income from other sources is less than $1,000 (single) or $2,000 (married or head of a family), he need not make an income tax return unless his gross income exceeds $5,000.[3]

LAW. Section 213. **That for the purposes of this title . . . . the term "gross income"— . . . .**

(b) Does not include the following items, which shall be exempt from taxation under this title:

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes;

The return of tax-exempt securities required under the old law is no longer necessary.[4]

Interest wholly exempt.—The obligations, interest upon which is wholly exempt, for all taxpayers, from surtaxes and excess profits and war profits taxes are:

1. The following bonds, certificates and notes issued under the Liberty Bond Acts and all United States obligations issued before September 1, 1917:[5]
   (a) The 3½ per cent First Liberty bonds, original issue, unconverted.

[3] See page 52.

[4] The 1918 law required wholly tax-exempt interest to be shown in the tax return only for information of the Treasury and not as a part of taxable income.

[5] Issued under the First Liberty Bond Act, approved April 24, 1917. Certificates of indebtedness issued under this act were also exempt.

(b) The 3¾ per cent Victory Loan notes issued under the Victory Liberty Loan Act, approved March 3, 1919. These bonds have been called for redemption June 15, 1922.

(c) Postal Savings deposits.[6]

2. Obligations issued under the Federal Farm Loan Act of July 17, 1916.[7]

Interest in no part exempt from surtax and excess profits tax.—The interest on 4¾ Victory Loan notes is subject to surtax and excess profits tax.[8]

Treasury notes issued under Victory Liberty Act are essentially different from Treasury certificates and are placed in the same class with Victory 4¾'s in so far as relates to exemption; in other words, there is no exemption on Treasury notes.

Interest subject to special exemption.[9]—The special exemptions in force under the 1918 law have been materially changed by the 1921 law. No longer does the original subscription to certain issues play a part in determining exempt interest; nor are there now any interrelated exemptions.

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[6] [Former Procedure] Only the interest credited on postal savings deposits prior to September 1, 1917, was exempt (Reg. 45, Art. 77). The 1918 law did not specifically exempt the interest from postal savings certificates of deposits as does the 1921 law [section 213 (b-4-c)].

[7] The constitutionality of these obligations was affirmed by the U. S. Supreme Court in *Smith v. Kansas City Title & Trust Co. et al.,* February 28, 1921; advance opinions, 65 L. Ed. 360.

[8] Under the provisions of the Victory Liberty Loan Act the Treasury made the following conditions applicable to issue of the Fifth Loan, in announcement made April 14, 1919.

"The Victory Liberty Loan, which will be offered for popular subscription on April 21, 1919, will take the form of 4¾ per cent three/four year convertible gold notes of the United States, exempt from state and local taxes, except estate and inheritance taxes, and from normal federal income taxes. The notes will be convertible, at the option of the holder, throughout their life into 3¾ per cent three/four year convertible gold notes of the United States, exempt from all federal, state and local taxes, except estate and inheritance taxes. In like manner the 3¾ per cent notes will be convertible into the 4¾ per cent notes."

[9] [Former Procedure] For details as to procedure under the 1918 law, see *Income Tax Procedure,* 1921, page 524 *et seq.*

The exemptions now applicable are indicated in the following:

LAW. Section 1328. . . . . (a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations or associations, in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German Government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

REGULATION. . . . . (3) 4 per cent and 4¼ per cent Liberty bonds (but not 4¾ per cent Victory notes), Treasury certificates of indebtedness, and Treasury (war) savings certificates are entitled to certain limited exemptions from surtaxes and excess-profits taxes now or hereafter imposed by the United States. . . . . For the period from January 1, 1921, to July 2, 1923, the total possible exemption from surtaxes and profits taxes amounts to $160,000, while for the period from July 3, 1923, to July 2, 1926, the total possible exemption amounts to $55,000, as follows:

Period Jan. 1, 1921, to July 2, 1923:

$5,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, fourth 4¼s, Treasury certificates of indebtedness, and Treasury (war) savings certificates.

30,000 of first second 4¼s.

125,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, and fourth 4¼s.

$160,000 total possible exemptions for this period.

Period July 3, 1923, to July 2, 1926:

$5,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, fourth 4¼s, Treasury certificates of indebtedness and Treasury (war) savings certificates.

50,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, and fourth 4¼s.

$50,000 total possible exemptions for this period. (Art. 84.)

The changes are effective as of January 1, 1921.

The Treasury, in administering the 1918 law, permitted the capitalization of the interest received on each issue at the appropriate rate and applied the exemption to the principal sum so obtained.

As indicated by the new forms (schedule E, form 1040, for individuals; schedule A-4, form 1120, for corporations), the Treasury has abandoned this practice. For example, assume the following:

4¼% Liberty bonds held for 6 months, January 1 to June 30, 1921, (par)		$200,000
6 months' interest on $200,000 at 4¼% is	$4,250	
Total maximum exemption		160,000
Principal amount in excess of exemption		$ 40,000
6 months' interest on $40,000 at 4¼% is the amount of taxable interest, viz.	$ 850	

Under the previous procedure the total interest received ($4,250) would be capitalized at 4¼ per cent, resulting in an "average principal" of $100,000, which is less than the $160,000 of exempt principal, so that none of the interest received ($4,250) would be taxable.

Exemptions not limited as to time.—It will be noted that the partial exemptions which are unlimited as to the time they remain in force are only of interest on $5,000 of the Second, Third and Fourth[10] Liberty Loans and on $5,000 of bonds of the War Finance Corporation. These two exemptions are entirely separate and a single taxpayer may have the benefit of both.

[10] This $5,000 exemption applies also to certificates of indebtedness and War Savings and Treasury Savings certificates, and War Savings Stamps.

$125,000 unconditionally exempt until 1923.—The 1921 law[11] consolidated the various exemptions granted under the several Liberty Bond Acts and supplements thereto, some of which were conditional, in order to simplify the computation of tax-exempt interest. By eliminating the conditions originally attached to some of the exemptions, the 1921 law has liberalized them. July 2, 1921, has been officially proclaimed as the date of the termination of the war with Germany, and thus the exemption periods referred to in section 1328 (a) expire on July 2, 1923, and on July 2, 1926, respectively. Therefore, in addition to the $5,000 exemptions referred to in the preceding paragraph, the interest on 4 or 4¼ per cent Liberty bonds is exempt up to a principal sum of $125,000 until July 2, 1923.

$50,000 unconditionally exempt 1923-1926.—After July 2, 1923, Liberty bonds of any issue bearing interest at 4 or 4¼ per cent are for a further period of three years, i.e., until July 2, 1926, exempt up to a principal sum of $50,000. This exemption is also in addition to the $5,000 exemptions already referred to.

Interest accrued upon conversion of Victory notes.[12]—

REGULATION. All interest accrued on 4¾ per cent Victory notes at the date of any conversion by the taxpayer into 3¾ per cent Victory notes shall, for the purpose of computing net income, be deemed to be interest upon 4¾ per cent Victory notes, and subject to surtaxes and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, associations, or corporations. Any and all amounts received by any taxpayer from the United States by way of adjustment of accrued interest upon the conversion of 4¾ per cent Victory notes into 3¾ per cent Victory notes shall be deemed to be interest upon 4¾ per cent Victory notes.

All interest accrued on 3¾ per cent Victory notes at date of any conversion by the taxpayer into 4¾ per cent Victory notes shall, for

[11] Section 1328. See page 683.

[12] For procedure on conversion of other issues of Liberty bonds, see *Income Tax Procedure*, 1921, page 540.

the purpose of computing net income, be deemed to be interest upon $3\frac{3}{4}$ per cent Victory notes and shall be entitled to the exemptions from taxation to which interest on $3\frac{3}{4}$ per cent Victory notes is entitled. (Art. 82.)

Exemption in case of fiscal years ending in 1921.—Due to the change in the exemption requirements, the interest accrued up to December 31, 1920, is exempted under the conditions imposed by the 1918 law, while that accruing after January 1, 1921, is subject to the 1921 law.

REGULATION. In the case of a return rendered for a fiscal year beginning in 1920 and ending in 1921, the interest received from obligations of the United States issued after September 1, 1917, is, in respect to the amount received prior to January 1, 1921, exempt only if and to the extent provided in the acts authorizing the issue thereof. See article 80, Regulations 45. The interest received on and after January 1, 1921, is exempt in accordance with the acts authorizing the issue thereof as amended and supplemented by section 1328 of the Revenue Act of 1921. See article 83. Since the basis of the exemptions is the principal amount of bonds held rather than the amount of interest received, where the holdings are not constant during the taxable period, if at any time the holdings of any issue or issues are less than the maximum exempted principal, then the exempted interest for such time shall be only the amount of interest received or accrued upon the principal actually held. (Art. 85.)

Exemptions when return is for period less than full year.—When return is made for a period less than one year, the 1921 law [section 226 (c)] provides that the net income "shall be placed on an annual basis."[13] The amount of taxable interest should be first computed before the net income is placed on an annual basis because such taxable interest is part of "net income."

Interest is income of year when due.—Under the present ruling of the Treasury all interest on bonds is income of the year when it becomes due, whether then collected or not.

Even when matured coupons have not been collected,

[13] See page 167.

they should, nevertheless, be included in the return. (Reg. 62, Art. 53.)

RULING. An owner of nontax-free Liberty bonds who has made an absolute gift of the coupons attached to the bonds covering interest due for a number of years will be required to include in his income tax return the interest which accrues each year on the bonds, and to pay any tax that may be due thereon. If the gift of the coupons is to an institution under section 214(a) 11, a deduction of such gift would be allowed in the annual income tax return. (C. B. 1, page 84; O. D. 120.)

Separate ledger accounts for interest.—The taxpayer should keep a separate ledger account for "interest received from Liberty bonds" to facilitate segregation of such parts thereof as are taxable and non-taxable. He should also keep a separate ledger account for "interest paid to carry non-taxable bonds" because such interest is not deductible from gross income. This account will not include any interest paid to carry obligations of the United States issued after September 24, 1917, including the 3¾ per cent Victory notes (if original subscriptions are by the taxpayer), because such interest is deductible.[14]

Accrual of interest on Liberty bonds.—The practice is common among business concerns to accrue other items of income and at the same time not to accrue Liberty bond interest. There is, however, no logical reason for not accruing such interest when other items of income and expense are accrued. The law requires that accounts be kept so as to reflect the actual net income of the taxpayer. The accrual method has been prescribed to accomplish this for business concerns.

For manner of treating interest on bonds purchased and sold between interest dates, see page 674.

Of the aggregate of possibly exempt principal of $160,000, all but $5,000 represents temporary exemptions; and if the taxpayer is to secure over a period of years the maximum

[14] Sections 214 (a-2) and 234 (a-2).

amount of exemption, he must make his return of income on the accrual basis. Returns on the cash basis would not entitle the taxpayer to the exemption of interest received on these issues after the temporary exemptions expire.

Discount on certificates of indebtedness.—

RULING. In the case of Treasury certificates of indebtedness which are offered by the Government at par and accrued interest and not at a discount, only the coupon interest can be considered exempt from normal tax, and from surtax to the extent provided by the Act approved September 24, 1917. Where such certificates are subsequently purchased at a discount, the difference between the purchase price and the par value of the certificates received at maturity is profit subject to both normal tax and surtax. The subscriber for Treasury certificates who sells them at a discount sustains a deductible loss, which is the difference between the par value of the certificates and the selling price. Any gain or loss on the sale of Treasury certificates of indebtedness prior to maturity should be determined in accordance with section 202 of the Revenue Act of 1918. (C. B. 3, page 123; O. D. 729.)

Individuals

The foregoing portion of this chapter applies to individuals as well as to other taxpayers, but the following points are applicable particularly to individuals.

Under the law individuals are taxed as such upon their income from partnerships in which they are members, from personal service corporations in which they are stockholders[15] and from estates and trusts of which they are beneficiaries. It is necessary, therefore, for the individual receiving Liberty bond interest from a partnership, a personal service corporation or a fiduciary to group all such interest received by issues and to calculate his exempt interest on the basis of his combined holdings of principal as an individual, as a partner, as a stockholder in a personal service corporation and as a beneficiary of an estate or trust. The various regulations of the Treasury do not specifically describe the manner in which the principal of Liberty bonds

[15] Up to December 31, 1921.

held by partnerships, personal service corporations, estates and trusts shall be apportioned among the individuals receiving the income therefrom other than to say that each partner, etc., is to be regarded as owning a "proportionate part" of the bonds. The assignment of holdings, however, should ordinarily be made on the basis of the share in profits or income received from the partnership, corporation or fiduciary.

The instructions on form 1040 for 1921 read:

Enter in column 5 on the proper lines the principal amounts of the various obligations owned in excess of the exemptions specified, during the taxable period, including your share of these obligations held by partnerships, personal service corporations and fiduciaries.

In case of a net loss for the year by the partnership, personal service corporation or estate, although the individual will show his share of Liberty bond interest received from the partnership, personal service corporation or estate, any undue increase of the taxable income of the individual thus apparently created will, in the case of partners and stockholders in personal service corporations, but not usually in the case of beneficiaries of trusts,[16] be offset by the share of the loss of the partnership or personal service corporation which the individual will also show in his return.

The regulations covering exemptions of Liberty bond interest received from partnerships, personal service corporations and fiduciaries are as follows:

REGULATION. (*a*) When income is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries periodically, each beneficiary is regarded as the owner of a proportionate part of the bonds held in trust and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trustee is regarded as the owner of all the bonds held in trust and the trust is entitled to exemption on account of such ownership. As to exemptions in the case of bonds beneficially owned by nonresident aliens, see article 94.

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[16] See Chapter XXXVII.

(*b*) As the income of a partnership is taxable to the individual partners, each partner is treated as the owner of a proportionate part of the bonds held by the partnership and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. This principle also applies to stockholders in personal service corporations during the calendar year 1921. (Art. 84.)

Partnerships

Since partnerships are not taxed as such, the question of Liberty bond interest received by a partnership is really a question for the individual partner in his separate return. The partnership return merely indicates the share of each partner in the Liberty bond interest received by the partnership.[17]

Stockholders in Personal Service Corporations

The question of taxable interest received by personal service corporations affects the income of the stockholders, as until January 1, 1922, they, not the corporation, are taxable on income received by or from it.[18] The exemptions of such stockholders are determined in the same manner as members of a partnership.[19]

Fiduciaries

Liberty bond interest received by executors, administrators, guardians, trustees and other fiduciaries is taxable to them only in case it is not distributable to the beneficiaries of the estate or trust.[20]

If the fiduciary is liable to tax, he is entitled to the same exemptions of Liberty bond interest as an individual.

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[17] [**Former Procedure**] Under the 1917 law partnerships as such were subject to the excess profits tax. T. D. 2762, dated October 21, 1918, provides that in calculating Liberty bond interest received by a partnership, which may be subject to excess profits tax, the partnership shall be deemed to be the owner of the bonds upon which the interest is received.

[18] See Chapter XXIV.

[19] See Art. 84, quoted above.

[20] See Chapter XXXVII, "Fiduciaries," for discussion of the cases in which fiduciaries must make a return and pay a tax. See also Art. 84, quoted above.

Corporations

The general statements on pages 680 and 684 in this chapter apply to interest on Liberty bonds received by corporations other than personal service corporations.

Exemptions of affiliated corporations.—

RULING. Each of several affiliated corporations included in a consolidated return under section 240 of the Revenue Act of 1918 is entitled to the same full benefits under the exemption provisions of the several Liberty bond acts to which it would be entitled if not affiliated. (C. B. 1, page 87; T. B. R. 7.)

Parent corporation may not apportion Liberty bonds held to its subsidiaries.—A parent corporation may not apportion Liberty bonds held by it among the affiliated corporations. If the parent corporation should make a bona fide sale of bonds to the subsidiary corporations, then such corporations would be entitled to the exemptions consequent on the holding of the bonds purchased, except that the status[21] of "original subscriber," heretofore discussed, would be lost.

Federal Land Bank bonds exempt.—The income from obligations issued under the Federal Farm Loan Act of July 17, 1916, is exempt from normal and surtax (including excess profits tax).

REGULATION. As section 26 of the Federal Farm Loan Act of July 17, 1916, provides that every Federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of Federal land banks and national farm loan associations and from interest on such farm loan bonds is not subject to the income tax. (Art. 75.)

[21] In view of the consolidation of the Liberty bond tax exemptions effected by section 1328 of the 1921 law, the status of "original subscriber" no longer has any importance, excepting with respect to the deductibility of interest paid to carry 3¾ per cent Victory notes.

United States Obligations Owned by Non-Resident Aliens, Foreign Corporations, etc.[22]

In order to encourage foreign investors to buy and hold Liberty bonds, Congress provided in the Victory Liberty Loan Act that obligations of the United States shall be exempt from federal, state and local taxes while beneficially owned by non-resident aliens and foreign corporations, partnerships and associations not engaged in business in the United States.

LAW. Section 4. **That section 3 of the Fourth Liberty Bond Act is hereby amended to read as follows:**

"Section 3. That, notwithstanding the provisions of the Second Liberty Bond Act or of the War Finance Corporation Act or of any other Act, bonds, notes, and certificates of indebtedness of the United States and bonds of the War Finance Corporation shall, while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, not engaged in business in the United States, be exempt both as to principal and interest from any and all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority."[23]

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[22] See Chapter XXXVI.
[23] Victory Liberty Loan Act, approved March 3, 1919, section 4.

CHAPTER XXI

INCOME FROM RENTS

Under each of the successive income tax acts rent has, in all cases, been made returnable as income subject to taxation.

> LAW. Section 213. . . . . **the term "gross income"— (a) Includes . . . . income derived from . . . . rent . . . .**

Income from rents may be reported on the accrual basis or on the actual receipt basis. If books of account are kept, all rents accrued, and believed to be collectible, should be reported. Any items found to be uncollectible may be deducted as losses in subsequent returns. If reporting on the accrual basis is not practicable or convenient, it is sufficient to return all rents received in cash during the tax year.[1]

No taxable income accrues where corporations, through book entries, have charged rental to construction accounts and credited an income account.[2]

Permanent improvements by lessees.—In several decisions the courts have held that title to improvements paid for by lessees vests in lessors as soon as made.[3] Prior to these decisions the Treasury held that the lessor was taxable on the value of improvements at the end of the lease.[4] Since these decisions the Treasury holds that the lessor may be taxable at the time when the improvements are made. In the opinion of the author the decisions merely reiterate many other court decisions and restrict the Treasury in its attempt to tax what is not income.

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[1] Rentals from "ground rents" as existing under laws of the state of Maryland should be returned each year as rent and are subject to tax as such. (B. 45-21-1905; O. D. 1089.)

[2] C. B. 4, page 276; O. D. 811.

[3] See page 697 *et seq.*

[4] **[Former Procedure]** For text of regulations in force prior to 1922 and criticism thereof, see *Income Tax Procedure*, 1920, pages 441-443, and *Income Tax Procedure*, 1921, pages 549-553.

The new regulations give the lessor the option of reporting any income derived from the making of improvements by the lessee either in one amount upon completion of the improvements or of spreading such income over the period of the lease.

The new regulations are as follows:

REGULATIONS. When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(*a*) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements.

(*b*) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each year of the lease an aliquot part thereof.

If for any other reason than a bona fide purchase from the lessee by the lessor the lease is terminated, so that the lessor comes into possession or control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on the cost or the value subject to the lease as of that date, whichever is lower, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. (Art. 48.)

The Treasury's interpretation of the earlier regulation illustrates the application of option (a) of the new regulation above quoted, as follows:

Ruling. A, in 1915, leases certain land to B for 20 years. B agrees, in part consideration for the lease, to erect on the leased ground a building, specifications agreed upon, of an estimated life of 25 years and to cost $50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of 25 years and cost of $50,000, the use and enjoyment of which is postponed for 15 years. The depreciated value of the building at the termination of the period of the lease will be approximately $20,000—that is, cost less depreciation sustained. The income of A, then, is the discounted value of $20,000 receivable at the end of 15 years. If market value reflects intrinsic value, this amount should equal the difference between the value of the land free from the lease without the buildings and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the taxpayer of the legal title to the encumbered building. Since A has included in income only the depreciated value of the building, he is entitled to a depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a "cost" value equal to the market value placed on the encumbered building by A in the year of its erection, i. e., the annual depreciation deduction for 1935 and subsequent years will be the quotient obtained by dividing (*a*) the value of the improvements to A as determined by him when the same completed became part of the realty, by (*b*) the number of years in the estimated remaining life of the improvements from the termination of the lease.

In any case in which the term of the lease is greater than the estimated life of the improvement no income should be accounted for by the lessor at the time of the passage of title. Also if the improvements will have no value at the termination of the lease, as is often the case in mining leases, no income is realized by the lessor. (C. B. 4, page 90; Mim. 2714.)

Option (b) in Regulations 62 is a reasonable basis if it can fairly be assumed that income arises annually out to the improvements paid for by the lessee.

Regulations 45, article 48, and the interpretation assumed several factors which reduced their value to nil.

Unimproved land upon which lessees erect buildings rarely increases in fair market value because of the improvements.

The maximum benefit which the lessor can realize during the lease is the rental reserved in the lease. The lessor will of course return the rent as gross income, but it cannot be claimed in most cases that additional income has been realized.

In the illustration it is assumed that a building erected by a lessee has a life of twenty-five years. Experience proves that buildings usually become obsolete within twenty-five years, particularly those erected by lessees for a special purpose. If lessors are required to report upon completion income equal to the estimated present value of the building, which in the illustration would be a substantial sum, where would the cash be found to pay the tax? A building might easily be completed near the close of a taxable year. There would be no income in that year from the lessee and the taxpayer might have no other source of income. How could it be held that he had taxable income to the extent of the present worth of a building in which he has no beneficial interest for fifteen years?

The author does not know of any such transaction which would result in taxable income. Article 48 as amended does not attempt to impute income where there is none. It merely states that the lessor may report as income (a) "the fair market value of such building or improvement subject to the lease," or (b) report as income the estimated depreciated value of the building or improvement over the life of the lease. It leaves to the lessor the fixing of the depreciated value. There may be some appreciation in value on account of the improvements, but any apparent appreciation is decidedly limited by the terms of the lease which, it may be assumed, expressly reserves to the lessee the full benefit and enjoyment of the improvements. The lessor does not pay for the improvements and it is not intended that he should receive much, if anything, more than the stipulated annual rental. As was said by Mr. Justice Pitney in the stock dividend case:[5]

> Enrichment through increase in value of capital investment is not income in any proper meaning of the term.

[5] *Eisner v. Macomber,* 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521.

In other words, there must be realization before there can be taxable income.[6]

In the old regulations the Treasury ignored the March 1, 1913, factor and attempted to impose income taxes upon property, which is unconstitutional. The new regulations are equally faulty in ignoring the trend of the decisions of the United States Supreme Court. It will probably be impossible to impose any income tax whatever on a lessor at the time when improvements are made, even though title vests simultaneously; but it may easily develop that at the end of a lease, when title, possession and enjoyment merge, there may be realized and taxable income equal to the fair market price (equivalent to cash) of the improvements.

DECISIONS. (Syl.) Where, in 1907, the owner of land leased the same for 23 years, under an agreement requiring the tenant to construct an expensive brick building, and on the tenant's default the owner retook possession in 1916, the value of the building cannot be deemed income accruing in the year 1917, within income tax law September 8, 1916, section 2 (a), for under the lease the title to the building vested in the owner immediately upon construction, and the lessee's default caused the owner a loss. (*Miller v. Gearin*, 258 Fed. 225, 169 C. C. A. 293; certiorari denied, 250 U. S. 667, 63 L. Ed. 1197, 40 S. Ct. 13.)

"The net income of a taxable person shall include gains, profits, and income derived from . . . . sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends . . . . or gains . . . . from any source whatever."

Plaintiff is the owner of a lot of land in the city of San Francisco, upon which, under the terms of a lease made by plaintiff in 1908 for a term of 26 years, there was erected by her tenant a class A steel and concrete building, the lease providing that "in no event shall the lessee hereunder have any right to remove any building from said premises." The building was completed in 1910. In 1916, the tenant defaulting in accrued rent, the lease was by mutual arrangement canceled and terminated, and possession of the leased premises surrendered to plaintiff.

The tax in question was assessed for the year 1916 upon the then value of the building erected under the lease, upon the theory

[6] See *Income Tax Procedure*, 1920, pages 441-443, and *Income Tax Procedure*, 1921, pages 549-553.

that the structure represented "gains, profits, and income" accruing to plaintiff for that year, under an interpretative rule of the Treasury Department, made for the guidance of taxing officers, that:

"Permanent improvements under lease or rental contracts, when improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation during the lease term, is gain or profit to the lessor at the end of the lease term, and is to be accounted for as income at that time." Paragraph 50, Regulations 33, Treasury Department.

The government claims that under the provisions of the act, and this regulation made thereunder, the tax was properly assessed and collected; but I am unable to sustain this view. The right to levy the tax turns upon the question: When did the title to this building vest in plaintiff and become a part of her property for the purpose of taxation? I am of opinion that under well-settled principles, aptly expressed in section 1013, Civil Code of California, the moment the building was erected, which the terms of the lease show was to become and remain an integral part of the land upon which it was constructed, the title thereto vested as completely in the plaintiff as though constructed by the plaintiff herself. The terms of the lease clearly disclose that the erection of the building was a part of the consideration for the lease, and that it was provided for and taken into consideration in the rent reserved. It therefore became, upon its completion, a part and parcel of plaintiff's income-bearing property, and was subject to taxation in her as of that date. *City of Oakland v. Albers Bros. Milling Co.* (Cal. App.), 184 Pac. 868.

The regulation of the Treasury Department cannot be applied to such a state of facts; if so intended, it must give way, as the department has no power to abrogate a substantive rule of law. This conclusion is not affected by the principles stated in *Board of Education v. Grant,* 118 Cal. 39, 50 Pac. 5; or *San Francisco v. McGinn,* 67 Cal. 110, 7 Pac. 187, relied on by defendant. Nor do the considerations urged by defendant as arising from the relation of landlord and tenant, between plaintiff and her lessee, apply to the terms of the lease here involved.

It results that whatever accession of value resulted to plaintiff's property from the erection of the building in question accrued and became vested in her in 1910, and not upon the termination of the lease. As this was prior to the enactment under which the tax was levied, the case falls by analogy within the principles of *Doyle v. Mitchell Brother's Co.,* 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054; and *Hays v. Gauley Mountain Coal Co.,* 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061. Those cases dealt with the act imposing a corporation excise tax, but, like the present act, the tax was imposed on income, and not upon capital invested, or property as such, and it was held that increase in the value of property invested, accruing

before the act took effect, could not be taken into account or treated as income not realized upon until after that fact. (*Cryan v. Wardell*, 263 Fed. 248.)

Guaranteed dividends or interest as rental equivalent.—It frequently happens that where one corporation leases the property of another corporation the lessee pays as rental a sum equal to the interest on certain securities or equal to a fixed dividend upon the capital stock of the lessor. The rental paid is a business expense of the lessee corporation and a rental income of the lessor corporation. The latter must so report the income even though the guaranteed dividends or the interest are paid directly to its stockholders.

The following ruling and regulation summarize previous rulings:

Ruling. A lessee corporation which owns a large part of the stock of the lessor corporation paid the annual rental of 50x dollars not directly to the lessor but as dividends to the stockholders of the lessor, retaining that part of the rental to which as a stockholder it was itself entitled. It is held that the lessor is required to include in its gross income for each of the years 1916, 1917, and 1918 the full annual rental of 50x dollars. (B. Digest 30-21-1747; A. R. R. 589.)

Regulation. Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the stockholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or stockholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the stockholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns. (Art. 547; Reg. 45, Art. 546.)

The procedure as outlined above is prescribed even in cases where special types of securities are issued in lieu of the capital stock of the lessor corporation. The ruling follows:

REGULATION. Stock trust certificates or leased line certificates, as the case may be, issued by the lessee for the purpose of securing or holding control of the stock of the lessor are held to be issued in lieu of the certificates of capital stock, and for the purpose of this tax will be treated as capital stock and the amounts received by the holders of these certificates are dividends to the holders, to be treated as rentals by both lessee and lessor and constitute an allowable deduction in the one case and an item of income in the other, accordingly as they are paid and received. (Reg. 33, 1918, Art. 104.)

These regulations have a perceptible effect upon the amount of the tax collected by the Treasury when, as under the 1917 law, there is a difference between the rate applied to corporations and the normal tax applied to individuals.[7]

Expenditures by lessees for taxes.—Many leases between landlords and tenants stipulate that the latter shall pay taxes or make necessary repairs. Expenditures of this character are considered a part of the rent and must be reported by the landlord.[8]

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[7] The decision upon which these regulations are based is in the case of *Rensselaer & Saratoga Railroad Company v. Irwin, Collector* (District Court, N. D., New York), March 5, 1917, 239 Fed. 739, decided under the Act of October 3, 1913; affirmed 249 Fed. 726, 161 C. C. A. 636; writ of certiorari denied by Supreme Court, 246 U. S. 671, 38 S. Ct. 424, 62 L. Ed. 931.

The 1918 law also had different 1919 normal rates for corporations and individuals but in case of dividends this makes no real difference as the receiving corporation (lessor) now pays no tax on dividends received.

[8] **[Former Procedure]** Under the law as it stood prior to October 3, 1917, it was incumbent upon tenants in certain circumstances to withhold the normal tax upon rentals paid. In such cases questions sometimes arose concerning the interpretation of agreements binding tenants to pay taxes in addition to a stipulated cash rental, the landlords insisting that income taxes so withheld should be assumed by the tenant, and the tenants contending that they should be deducted from the stipulated cash rental agreed upon.

On September 21, 1916, in the case of *Suter et al. v. Jordan Marsh Co.* (Supreme Judicial Court of Massachusetts, 225 Mass. 34, 113 N. E. 580), the court decided that the tenant could not deduct from its rental the normal federal income tax, having agreed to pay "all taxes and assessments . . . . upon *or in respect of* the rent payable hereunder by the lessee, howsoever and to whomsoever assessed." The court stated that a change in the

Regulation. . . . . Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. . . . . (Art. 109.)

Since the net income of the owner is the same whether or not the taxes paid are included as income, many owners do not report as called for by the regulation because they have no personal knowledge of the amount of taxes paid.

Decision. A rental contract entered into in 1896 contained the provision that the lessee should pay, among other things:

"One-third of all taxes or assessments, special or otherwise, and public charges of every kind and nature that shall or may be taxed or assessed against the (lessor) or its property during the aforesaid term of years."

The question at issue was whether the federal income tax and the federal capital stock tax were to be deemed embraced in the contract and to be an obligation of the lessee. The court, approaching the question from the standpoint of the circumstances surrounding the parties, in an endeavor to interpret the intent, considered that the fact that the taxes in question were not in force when the contract was made was a pertinent circumstance and one which had led the courts in other jurisdictions to limit the meaning to be given to the taxes mentioned in the contract.

It passed to the consideration of cases where an income tax was itself involved, concluding that none of them could be held to require the payment of such a tax, and hence it held here that no such obligation was found to be in the contract nor was it necessarily or even reasonably to be implied from the language used.

The same reasoning was applied to the consideration of the federal capital stock tax or excise tax, which was also held to be beyond the contemplation of the parties.

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law as to taxation during the term of the lease is of no consequence. "The covenant is to pay all taxes except betterments." The court held: "The defendant seeks to deduct from the rent reserved that which it contends it already has paid as a tax, being obligated to pay all taxes assessed on account of that rent. That it cannot do."

In another case, *Little Schuylkill Navigation R. R. and Coal Co. v. Phila. & Reading Ry. Co.* (44 Penn. County Court Reports 197), a lessor attempted to hold the lessee liable for the normal tax under a clause in a lease obligating the lessee to pay taxes, but here the provisions as to the kind of taxes the lessee should pay were held by the court to be not inclusive enough to subject it to the federal income tax. The lessee agreed to pay "all taxes, charges, and assessments . . . . assessed or imposed under any existing or future law on the demised premises . . . . or on the business there carried on or on the receipts . . . . derived therefrom, or upon the capital stock . . . . dividends . . . . or . . . . franchises of the (lessor)."

The court therefore held that the lessor was not entitled to recover upon either item of its claim for reimbursement for the taxes paid by it. (*Des Moines Union Ry. Co. v. Chicago Great Western Ry. Co.*, 177 N. W. 90.)[9]

Rent received other than in cash.—An owner of property must return for taxation all income therefrom whether received in cash or in the equivalent of cash. Many farms are leased under agreements which provide that the lessor shall receive as rental a certain portion of the crops. The lessor must return for taxation the fair value, less all expenses incurred, of the commodities received if consumed or disposed of by gift and must return the net proceeds if sold for cash.

Houses, etc., occupied by rent-free tenants.—It may be that neither cash nor produce is collected from the occupants of houses, farms, etc., but the equivalent thereof is realized by the owner in a different form.[10] A taxpayer may own a garage large enough to accommodate the family of a chauffeur. The wages paid to the chauffeur in such cases will usually be less than if he were obliged to live elsewhere and pay rent. Since the saving in wages is a direct reduction of personal or living expenses, there should be returned for taxation by the chauffeur an amount equal to the saving. The same rule applies to tenants' houses on farms and country places.

As heretofore stated, the rental value of a taxpayer's residence, when occupied by himself, is not taxable, but it cannot be assumed that such exemption extends to other residences which are occupied by employees whose services are not of a gainful nature. Should not the decrease in the expenses of the employer be deemed to be constructive income?

Under the 1921 Revenue Act, the rental value of a dwelling house furnished to a minister of the gospel as part of his compensation is not to be included in taxable income.[11]

[9] *Bulletin of The National Tax Association*, November, 1920, page 51.
[10] See page 438.
[11] Section 213 (b-11).

CHAPTER XXII

INCOME FROM DIVIDENDS

The taxation of dividends presents certain difficulties which do not exist in the taxation of other income. Dividends are paid from the surplus earnings of corporations and as corporations have been continuously taxed on net earnings since the incidence of the federal income tax on March 1, 1913, taxation of the same earnings when distributed to stockholders would result in double taxation if provision were not made for a proper adjustment. Again, earnings distributed since March 1, 1913, out of the surplus accumulated prior to that date are sometimes held to be capital and sometimes taxable income.[1] As surtaxes are not imposed upon corporations Congress has attempted to devise various methods of compelling corporations to declare dividends, or to penalize the corporations which do not make adequate distributions of profits.[2] Other complications exist which will be discussed hereinafter. The successive federal income tax laws and the decisions of the Supreme Court of the United States are gradually clearing up disputed points.[3]

Dividends are taxable.—

LAW. Section 213. **That for the purposes of this title . . . . the term "gross income"—**

(a) Includes gains, profits, and income derived from . . . . dividends. . . . .

Dividends are relieved from normal tax.—Previous federal income tax laws have provided that dividends received by in-

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[1] See page 715.
[2] See Chapter XXXV, "Tax on Undistributed Profits."
[3] In view of many unsettled cases relating to returns going back to 1913, it is deemed necessary to include in this chapter copious references to past regulations and decisions. For full details, however, the reader is referred to *Income Tax Procedure*, 1918, 1919, 1920 and 1921 editions.

dividuals are not subject to the normal tax.[4] The 1921 law denies the credit of dividends for normal tax purposes in two cases, i.e., when received from:

1. Corporations entitled to benefits of section 262 (those deriving most of their income from sources within United States possessions).
2. Foreign corporations 50 per cent of whose gross income for the preceding three-year period is from sources *without* the United States.[5]

LAW. Section 216. [Individuals]. **That for the purpose of the normal tax only there shall be allowed the following credits:**

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (2) from a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217; . . . .

Section 234 (a-6) provides, in practically identical language, for the deduction of dividends in computing the net income of corporations.[6]

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[4] In the case of state income taxes the foregoing provision does not necessarily apply because corporations may not pay a state income tax as such. In New York State, corporations pay a 4½ per cent tax on net incomes, but it is imposed as a franchise tax. Consequently an individual taxpayer must pay state income tax on the full amount of dividends received, with no allowance or credit for the 4½ per cent already collected on the same net income.

[5] See page 711 for discussion of reason for limitation of credit.

[6] [Former Procedure] Under the 1909 excise tax law corporations were not subject to tax upon dividends. Under the 1913 and 1916 laws they were taxed. Under the 1917 law they were taxed 2 per cent when out of 1916 or 1917 earnings and 1 per cent when out of 1913, 1914 or 1915 earnings, and exempt as to the 4 per cent war income tax. The 1918 law relieved corporations from any tax on dividends received from other corporations which were themselves taxable under the federal income tax law.

Corporation tax rates were as follows: 1913, 1914, 1915, 1 per cent; 1916, 2 per cent; 1917, 2 per cent and 4 per cent war income tax.

Dividends from corporations taxed upon their net income in Porto Rico and the Philippine Islands were not allowed as credits, free of tax, in an individual return and were not allowed as a deduction in arriving at net income in a corporation return. (1918 law, section 261.)

Dividends on stock of federal reserve banks exempt from both normal and surtaxes.—

REGULATION. As section 7 of the Federal Reserve Act of December 23, 1913, provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, such exemption attaches to and follows the income derived from dividends on stock of Federal reserve banks in the hands of the stockholders, so that the dividends received on the stock of Federal reserve banks are not subject to the income tax. Dividends paid by member banks, however, are treated like dividends of ordinary corporations. (Art. 76.)

The above regulation calls attention to the fact that this exemption of dividends received by member banks does not extend to dividends paid on the stock of member banks.

Owners of record liable for tax—Exception.—Many stocks are owned by others than shareholders of record. In such cases the following regulation is of importance:[7]

REGULATION. Dividends on stock of domestic corporations or resident foreign corporations are prima facie income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure of the actual ownership is made to the Commissioner on Form 1087 which shall show that the record owner is not the actual owner and who the owner is and his address. In all cases where the actual owner is a nonresident alien individual and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control, and disposal of the dividend income and will be required to make return for the actual owner, regardless of the amount of the income, and to pay any surtax found by such return to be due. (Art. 405.)

"Dividend" Defined

The statutory definition of the term "dividend" follows:

LAW. Section 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234[8] and paragraph (4) of subdivision (a) of section 245[9] means any distribution

[7] See also page 320.

[8] Refers to distributions by insurance companies (other than life).

[9] Refers to distributions by life insurance companies.

made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913, except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922. . . . .

The 1921 law eliminates from the definition a distribution "in stock of the corporation" (stock dividends), as well as distributions from personal service corporation earnings which were accumulated during the period that such earnings were taxed to the individual stockholders. The words "earnings or profits," which are the same as in the 1918 law, were held to include realizations of appreciation accrued prior to March 1, 1913. The ruling is believed to be illegal.[10]

The definition given in the regulations limits the meaning of the term still further:

Regulation. Dividends for the purpose of the statute comprise any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. . . . . The term "dividends" does not, however, include a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922. . . . . (Art. 1541.)

Distribution must be "in the ordinary course of business."—It should be noted particularly that the regulation just quoted insists that the distribution shall have been made "in the ordinary course of business." The phrase evidently is meant to distinguish such dividends from liquidation or dividends extraordinary.[11]

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[10] See page 718.

[Former Procedure] The definition in the 1918 law is:

Law. Section 201. "(a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918."

[11] See page 748.

What constitutes a distribution?—The 1921 law now provides, in effect, for the constructive receipt[12] of dividends.

LAW. Section 201. . . . . (e) **For the purposes of this Act, a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands. . . .**

REGULATION. . . . . A taxable distribution made by a corporation to its stockholders or members shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. (Art. 1541.)

Very few stockholders have available or trustworthy information as to when dividends are declared. Their records show only the receipts of dividends, even when accounts are kept on an accrual basis. It would be rather difficult for a taxpayer keeping accounts on a cash basis to make the necessary adjustments at the beginning and end of each year; therefore stockholders who report dividends as of date of receipt, which is the first time they are under the control of the stockholders, will be complying with the law.

In the case of close corporations the individual accounts of stockholders may be treated as bank accounts and it is reasonable to charge such stockholders with notice as to the dates when dividends are credited.

DECISION. . . . . It appears that in the year 1916 the earnings of the company were distributed to the stockholders by crediting them with their pro rata shares thereof upon the books of the corporation. This dividend was not, however, actually segregated from the general assets of the company. Godfrey F. Park thus received credit for $21,120.94 and Susan R. Park for $17,836.33.

It is well settled that the declaration of a dividend creates a debt from the corporation to the stockholders. If the amount of the dividend be segregated and set apart from the other corporate assets in money or securities or other property, then the same becomes a trust fund, for the benefit of the stockholders, respectively. But that does not seem to have been done in this case. Therefore, the crediting of the pro rata shares of the plaintiffs, Godfrey F. Park and Susan R. Park, of this amount to their respective accounts

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[12] See page 387.

upon the books of the company merely evidenced the indebtedness of the company to them, and did not constitute the receipt of income by them. Income means actual cash or its equivalent received, as opposed to contemplated revenue due or unpaid. *Maryland Casualty Co.* v. *U. S.*, 52 Ct. Cls. 201 209 (Affirmed 251 U. S. 342, 345.)

Although the dividends were not income simply because credits to the extent thereof had been created, yet when the plaintiffs subsequently drew, as they did, against those credits and obtained the money thereon, then they did become income. . . . .[13]

In the foregoing case the court was satisfied that certain stockholders could not be charged with the constructive receipt of their dividends, even though credited to their individual accounts in the books. Under the 1921 law such dividends would be taxable unless the company could not pay the amounts credited.[14]

May a dividend be rescinded by directors or returned by stockholders?—It sometimes happens that a dividend is declared on the strength of book or paper profits and subsequently it becomes necessary or desirable to reverse the action and arrange to secure a return of the funds paid out or credited to the accounts of stockholders.

If a single stockholder objects to the rescinding proposition after the formal declaration of a dividend is communicated to him or after the dividend has been credited, no legal remedy

[13] *Park v. Gilligan, Collector,* U. S. Dist. Ct., So. Dist. of Ohio, West. Div., June 11, 1921 (not reported); see Corp. Tr. Co. 1921 *Income Tax Service,* 3067 *et seq.*

[14] [Former Procedure] Under the 1918 law the Treasury imposed an impossible condition upon stockholders who keep their accounts on a cash basis.

RULINGS. "The date of payment rather than date of receipt is the governing factor in determining when a dividend should be treated as taxable income to the recipient. Consequently, a dividend paid in Kansas and received there by stockholders December 30, 1917, but not received by stockholders in California until January, 1918, will be taxable at 1917 rates to the California stockholders." (C. B. 1, page 562; O. D. 97.)

"A distribution by a corporation in 1919 under court order of an accumulated cash surplus, as a result of suit brought by certain stockholders, which was decided in their favor by the lower court in 1917 and affirmed by the appellate court in 1919, must be returned as income of the stockholders for the year 1919 and not in amended returns for 1917." (C .B. 2, page 87; A. R. R. 124.)

is available to compel action on his part. If, however, in fact the dividend has been paid out of capital, the so-called dividend is not taxable at all to the stockholders and the directors may be required to reimburse the corporation to the extent to which the dividend was illegal.[15]

RULING. A dividend declared and paid by a corporation was in part illegal, inasmuch as it exceeded the true earnings, and the corporation later rescinded it. To the extent that the corporation had a legal right to force rescission and repayment of such dividend, and such rescission and repayment were actually made, the rescinded dividend should not be considered income to the stockholders for the purpose of taxation. (C. B. 1, page 25; T. B. M. 77.)

But if every stockholder consents to a rescission the case is entirely different. If directors pay a dividend which proves to be unwise, or excessive or illegal, and every stockholder agrees to return the amounts paid or credited, it may be expected that no court will hold that the payments represent income when received and capital payments when refunded, even though the dividends were paid or credited during one taxable year and the refunds occurred during the next year.

If the entire transaction occurred during the same taxable year it would not even appear in the returns or accounts of the taxpayer. In effect it would be a transaction marked "void." Therefore, when one part of the transaction occurs very late in one taxable year and the other part in the next taxable year a taxpayer should not be penalized thereby.

This, however, is not the view of the Treasury.

RULING. A corporation in due course of business during the calendar year 1918 declared and paid a dividend the major portion of which was paid out of earnings of the calendar years 1914, 1915, and 1916. Both at the time of declaration and at the time of payment of such dividend the Revenue Act of 1916 as amended by the Revenue Act of 1917 (see sec. 31 (b)) was in force, which provided for the taxation of dividends "at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation." In the calendar year 1919, after the passage of the Revenue Act of 1918 which changed the method of taxing

[15] *Auditing, Theory and Practice* (1921 edition), by R. H. Montgomery, pages 670-677.

cash dividends so that they became taxable at current rates, the corporation took action purporting to rescind the declaration of the dividend, and the stockholders repaid the amounts received by them from the corporation. It is inferred from the statement of facts that the declaration and payment of the dividend were legal and that the corporation could not have required the stockholders to pay back the amounts received in distribution but that such repayments were made voluntarily. . . . .

The rights of the stockholders with respect to the dividend became fixed at some time not later than the date of payment thereof. Such rights were not subject to any liability to repay amounts received. The dividend, therefore, became during the calendar year 1918 a part of the gross income of the stockholders. After it had acquired the character of gross income the stockholders could not by voluntary action on their part take away such character. The repayment of the dividend was a new and independent transaction. . . . . (C. B. 1, page 65; T. B. R. 42.)

The author wholly disagrees with the foregoing ruling. When the dividend was declared and paid the stockholders were justified in assuming that Congress would keep faith with the corporations which were induced to pay special dividends in 1918 under a guarantee of special treatment.[16] Congress did not keep faith and later imposed a different rate of tax by retroactive legislation. The corporations having acted under a law which was subsequently repealed were legally entitled to rescind what was done under a mistaken idea of the good faith of the government. The government having secured action through deceit is estopped from benefitting by such action.

In a subsequent case, the Treasury held the repayment of a dividend did not relieve the stockholders of surtax thereon, even though the original payment of the dividend was made before proper provision had been made for federal taxes, resulting in an impairment of capital.

RULING. At the time of the declaration of the dividend the corporation had earnings and profits accumulated since February 28, 1913, out of which the dividends could be paid. In December, 1919, additional income and excess profits taxes were found to be due from this corporation for the year 1917, the collection of which would

[16] See page 732.

seriously have impaired the capital of the corporation. It was therefore agreed at a meeting of the stockholders, held in December, 1919, that the dividends previously paid should be returned to the corporation. . . . .

It might be inferred that no dividends may be declared from surplus and undivided profits unless a reserve fund is established for the payment of any Federal taxes which might accrue for the year prior to that in which the dividend is declared. However, such a principle could not be applicable to all prior years in which additional assessments might be made. The Commissioner is empowered, under the Revenue Act of 1918, to make an additional assessment of income and excess profits taxes for any given year at any time within five years after the return was due or was made, and in the case of a false or fraudulent return with intent to evade the tax the amount of tax due may be determined and collected at any time after the return is filed (section 250 (d)). It is apparent, therefore, that if we are to take into consideration a contingent liability that arises by reason of additional assessment, no point of time will arrive at which directors may safely say that earned surplus and undivided profits are available for distribution to stockholders in the form of dividends. (C. B. 4, page 73; Sol. Op. 110.)

The foregoing ruling is not sound. The repayment of the dividend was an honest and legal method of rectifying a mistake. The attempt of the Treasury to force the payment of income taxes on an improper diversion of funds, ignoring the return of the funds, is inexcusable.

In a recent case[17] the Treasury held that under almost similar circumstances the taxpayer could make an amended return for the year when the dividend out of capital was received, on the ground that it was not income.

Distributions by foreign corporations considered "dividends."—In the definition quoted on page 705 the term "dividend" is held to include a distribution by a foreign as well as by a domestic corporation, but the 1921 law[18] imposes a definite limitation on such dividends before they can be free of the normal tax in the hands of individual stockholders, or from income tax imposed on a corporation recipient, i.e., more than

[17] See I-3-27; I. T. 1164.

[18] Sections 216 (a), 234 (a-6).

50 per cent of the gross income of the foreign corporation paying the dividend, for the three-year period prior to declaration of the dividend, must have been from sources *within* the United States.

The insertion of this limitation in the 1921 law was to prevent the recipient of dividends from a foreign corporation securing credit for normal tax on income even though normal tax has never been paid by the foreign corporation. In other words, if the business of a foreign corporation in the United States is so small or so unprofitable as to yield little or no tax, the recipient of dividends will not now secure credit for a tax which has not been collected from the corporation.[19]

Method of return of dividends from foreign corporations. —Receipt by an individual of a $250 dividend on the ordinary shares of a British company indicates that the dividend credited was $357.14 and that the company paid to the British government an income tax of 30 per cent, or $107.14. The gross amount ($357.14) should be entered in the return as a dividend subject to surtax only, and credit is taken for the full amount of the tax ($107.14). This applies when the British company received more than 50 per cent of its gross income for the three-year period preceding the declaration of the dividend, from sources within the United States. When the British company received less than 50 per cent of its gross income from the United States as above noted, the full dividend ($357.14) must be entered as subject to both normal tax

[19] [Former Procedure]

RULING. "Individuals are entitled to a credit for the purposes of the normal tax, of dividends, regardless of the amount of such dividends, received from a foreign corporation taxable upon income from sources within the United States, irrespective of the amount of such income. This applies equally to the Revenue Acts of 1916, 1917 and 1918. The same credit is allowed to corporations under the Revenue Act of 1917, for the purpose of the 4 per cent war income tax imposed by section 4 of that Act, but not for the purpose of the 2 per cent tax imposed by section 10 (a), Revenue Act of 1916 as amended by the Revenue Act of 1917." (C. B. 2, page 159; O. D. 383.)

and surtax, but credit is taken for the 30 per cent tax ($107.14).[20]

Distributions received from personal service corporations after January 1, 1918, may or may not be "dividends."—Distributions by personal service corporations lose their character as "dividends" when made out of earnings or profits accumulated after December 31, 1917, and prior to January 1, 1922.

LAW. Section 201. (a) That the term "dividend" . . . . means any distribution made by a corporation to its shareholders or members, ... except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922. . . . .

Any distribution received from a personal service corporation must be analyzed. If declared out of earnings accumulated after December 31, 1917, and prior to January 1, 1922, it must not be treated as a dividend. If the personal service corporation has not paid the tax on it, it is subject both to the normal tax and to the surtax in the hands of the recipient. If declared from earnings accumulated prior to January 1, 1918, or after December 31, 1921, it is subject to the surtax or exempt from all tax, the same as an ordinary cash dividend would be.

The reason for this is that prior to January 1, 1918, for income tax purposes, personal service corporations were taxed like regular corporations and paid the normal income tax on their earnings up to the end of 1917. Beginning with January 1, 1918, personal service corporations were not subject to income tax, but their earnings were taxed to the individual stockholders.[21] Under the 1921 law [section 218 (d)], personal service corporations, after December 31, 1921, will again be taxed like regular corporations. Thus, to determine

[20] See Chapter XXXVI for limitation on credit for foreign taxes.

[21] 1918 law, section 218 (e).

whether or not a "dividend" from a personal service corporation is taxable, it is necessary to consider three periods:

1. March 1, 1913, to December 31, 1917, inclusive.
2. January 1, 1918, to December 31, 1921, inclusive.
3. After December 31, 1921.

If the "dividend" is from earnings accumulated during (1) and (3), it is only subject to surtax, like a regular dividend. If from (2), it is not a "dividend" at all and is not subject to tax in the hands of the recipient since the tax on such earnings has already been imposed on the individual stockholders.[22] Earnings prior to March 1, 1913, are tax-exempt when distributed by personal service corporations, just as are the earnings of ordinary corporations.

Dividends from personal service corporations derived from earnings accumulated after December 31, 1917, and prior to January 1, 1922, are to be treated as income from a partnership. Therefore income received by the personal service corporation, such as tax-exempt interest or dividends from federal land banks or national farm loan associations, should have been reported to the stockholders separately, in order that the exemption to which the stockholders are entitled would be secured. In making return on form 1040 the stockholders should segregate the receipts from personal service corporations after December 31, 1917, and not include any dividends which constitute a distribution of profits accumulated after December 31, 1917, and prior to January 1, 1922. The part of the undistributed income of the personal service corporation which accrued to the stockholders after December 31, 1917, should be reported in the year of accrual as Item 9, schedule E of form 1040. Dividends received by stockholders of personal service corporations after January 1, 1918, which constitute a distribution of earnings prior to that date, should be reported the same as dividends from ordinary corporations.

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[22] For discussion of personal service corporations having fiscal years, see page 820.

For 1922 and subsequent years, dividends received out of earnings accumulated after December 31, 1921, will also be entered the same as dividends from ordinary corporations. After December 31, 1921, dividends paid by personal service corporations are subject to the provisions of section 201 (b).[23] Dividends paid during 1922 will be applied first to earnings accumulated ratably during 1922. If a personal service corporation declares a dividend in March, 1922, payable April 1, 1922, it will be held that it must first be applied against earnings accrued from January 1 to March 31, 1922, even though tax-exempt earnings accumulated prior thereto have not been distributed. It would appear to be advisable for all personal service corporations which have available funds, to pay dividends immediately in order that the greater part thereof may be apportioned as tax-exempt to the period prior to January 1, 1922. The payment may be made by declaration that all such accumulations be credited as dividends to the personal accounts of the stockholders.

Assume a personal service corporation had a surplus at December 31, 1921, of $200,000, all accumulated since January 1, 1918. The normal tax and surtax thereon will have been paid by the individual stockholders. Assume further that the earnings from January 1 to February 28, 1922, are $20,000. On February 28, 1922, a dividend of $15,000 is paid. The sixty-day rule is not applicable. The entire dividend of $15,000 would be deemed to be out of 1922 earnings and taxable to the stockholders at the 1922 surtax rates, but exempt from normal tax. No part of the $200,000 surplus may be distributed free from tax until all earnings since December 31, 1921, are first distributed.[24]

Distributions Which Are Not "Dividends"

Three types of so-called "dividends" may be excluded from gross income:

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[23] See page 728.

[24] Section 201 (a). For further discussion see pages 721-725.

1. From earnings accumulated prior to March 1, 1913.
2. From appreciation at March 1, 1913.
3. Liquidating dividends, to the extent that they are a return of capital. Included hereunder would be dividends stated to be paid from depletion and depreciation reserves.

LAW. Section 201. . . . . (b) . . . . any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. . . . .

The words "or increase in value of property" in the 1921 law are new, and were inserted so as to remove all doubt[25] that dividends paid out of appreciation at March 1, 1913, are not taxable, provided the earnings accumulated since that date are first distributed.

REGULATION. Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase of value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition), is not a dividend within the meaning of the Act. The provisions of the preceding sentence shall be applied uniformly to cases arising under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, as well as the Revenue Act of 1921. A corporation can not distribute earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed. In determining whether a dividend is out of earnings or profits accumulated prior or subsequent to March 1, 1913, due consideration must be given to the facts and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. . . . . (Art. 1543.)

In the opinion of the author the foregoing regulation correctly interprets the provision regarding dividends paid from realization of appreciation at March 1, 1913, which while new in the 1921 law, in no way change the clear language and intent of the 1916, 1917 and 1918 laws. As the new provision di-

[25] For ruling of the Treasury that under the 1918 law dividends paid out of realized appreciation at March 1, 1913, are taxable, and discussion thereon, see pages 718 to 721.

rectly concerns dividends paid in recent years, the history of the dividend sections of the various laws will be discussed in full.

Under the 1913 law the Supreme Court has held that cash dividends declared between March 1, 1913, and December 31, 1915, even though admittedly out of surplus accrued prior to March 1, 1913, are taxable.[26]

The decisions would seem to be controlling so far as ordinary cash dividends paid prior to December 31, 1915, are concerned, but in other decisions[27] the Supreme Court has held that special circumstances would justify a departure from the former decision, so that cash dividends paid after March 1, 1913, have in some cases been held free from taxation and in other cases subject to the tax.

1916 LAW. Section 31. **(a) That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company. . . . .**

The 1916 law definitely declared that earnings accumulated prior to March 1, 1913, had been capitalized and that dividends therefrom were free from all income taxes. No provision was made that the earnings subsequent to March 1, 1913, should be exhausted before declaring dividends out of the prior period.

Under the 1916 law the Treasury made no effort to restrict the payment of dividends out of surplus accrued prior to March 1, 1913, but very properly required evidence that the corporations were keeping strict account of the disposition of the surplus at that date.

The Treasury Department consistently interpreted the 1916

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[26] *Lynch v. Hornby*, 247 U. S. 339 (June, 1918); *Peabody v. Eisner*, 247 U. S. 347 (June, 1918).

[27] *Southern Pacific Co. v. Lowe*, 247 U. S. 330 (June 3, 1918); *Gulf Oil Corpn. v. Lewellyn*, 248 U. S. 71 (December 9, 1918); see page 739.

law to mean that a board of directors might specify the period to which dividends applied, and, if a surplus existed at March 1, 1913, and a board of directors informed stockholders that a certain dividend applied thereto, such dividend was not returnable and of course not taxable to the stockholder.

In the first drafts of the revenue bill of 1917 it was provided that all dividends declared during 1917 were applicable first to the latest earnings of corporations. As many special cash and stock dividends (declared after January 1, 1917) had been designated as payable out of surplus at March 1, 1913, and as most such dividends would not have been paid at all if subject to the 1917 income tax rates, great injustice would have been done if no change had been made in the draft.

It was finally decided that the application of dividends to the latest earnings should be obligatory only from August 6, 1917. This was the date on which the Senate Finance Committee reported the revenue bill as amended to the Senate. As reported, the bill indicated the intention to compel the distribution of all earnings subsequent to March 1, 1913, before the surplus at that date could be distributed. This was sufficient notice of a radical change in the 1916 law, and directors who declared dividends during 1917 but after August 6, were chargeable with a knowledge that the 1916 law was to be amended.[28]

Dividends out of surplus prior to March 1, 1913.—The following opinion of the Solicitor of Internal Revenue which has been overruled by article 1543 of Regulations 62 is of more than ordinary interest because it held that certain dividends, theretofore believed to be exempt from tax, are taxable.

RULING. The following question is raised: Is the profit made by a corporation in 1918 or subsequent years, from the realization of the appreciation of the March 1st value of property (that is, the profit realized between cost and March 1st value of property sold in 1918

[28] See Reg. 33, 1918, Art. 107; and C. B. 3, page 36; O. D. 655.

or subsequent years), *taxable as income*, when distributed as a *dividend* to a stockholder in 1918 or subsequent years?

To illustrate the point, the M Corporation purchased capital assets in 1910 for $10,000. On March 1, 1913, these assets had a value of $20,000. In the year 1918 or a subsequent year the M corporation sells these assets for $20,000 and distributes the $10,000 realized gain to its stockholders as dividends. The question asked is whether the $10,000 thus distributed is taxable as income to the stockholders.

It was held in *Lynch* v. *Hornby*, 247 U. S. 339 (T. D. 2731), that such increase in the value of corporate assets accrued prior to March 1, 1913, was taxable income under the Income Tax Act of 1913 when distributed as a dividend in the ordinary course of business. The court stated:

> Hence we construe the provisions of the Act that "the net income of a taxable person shall include gains, profits, and income derived from . . . . interest, rent, dividends, ... or gains or profits and income derived from any source whatever" as including (for the purposes of the additional taxes) all dividends declared and paid in the ordinary course of business by a corporation to its stockholders after the taking effect of the Act (March 1, 1913), whether from current earnings or from the accumulated surplus made up of past earnings or *increase in value of corporate assets*, notwithstanding it accrued to the corporation in whole or in part prior to March 1, 1913. (Italics mine.)

The definition of income contained in section 213, Revenue Act of 1918 is, in its essentials, the same as the definition in the Act of 1913, and it follows, therefore, that unless Congress has by other statutory provisions exempted such income it is taxable.

Pertinent provisions in the Revenue Act of 1918 bearing on this point are section 201 (a) and (b) which provide as follows:

> (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation, ... to its shareholders or members, ... out of its earnings or profits accumulated since February 28, 1913. . . . .
>
> (b) . . . . any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, or, in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

It seems clear that the distribution here in question is a "dividend" within the meaning of section 201 (a), which defines a dividend as "any distribution made by a corporation, ... out of its earnings or profits accumulated since February 28, 1913." Mere

increase of capital assets unrealized is not, in our judgment, "earnings or profits." Obviously it is not an earning. Is it a "profit," as that term has come to be understood in income tax parlance? In *Lynch* v. *Turrish*, 247 U. S. 221, the Supreme Court quoted with approval the following from *Gray* v. *Darlington*, 15 Wall. 63:

Mere advances in value in no sense constitutes the gains, profits, or income specified by the statute.

In *Eisner* v. *Macomber*, 252 U. S. 189, the court in commenting on the meaning of income states:

Here we have the essential matter: *Not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment, but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, ...

Here profit is made synonymous with income, and income is held not to include mere appreciation of capital. Hence the word "profit" can not include mere appreciation of capital. The statute, section 213, defines income as including "profits." Surely a part can not be said to be greater than the whole as that whole has been defined by the Supreme Court. See also article 23, Regulations 45, holding appreciation of capital is not income.

Such appreciation becomes income, or profit, however, when realized through the sale of such assets (*Merchants Loan & Trust Co.* v. *Smietanka*, decided by the Supreme Court, Mar. 28, 1921; T. D. 3173, C. B. 4, p. 34). It is clear, therefore, that this increase did not become "earnings and profits" to the corporation until after February 28, 1913. Therefore any distribution out of it must have been a distribution out of the earnings and profits accumulated after February 28, 1913. That such increase when realized is not taxable to the corporation because accrued prior to March 1, 1913, is immaterial. The definition of a dividend does not confine itself to taxable or nontaxable earnings or profits. It is concluded, therefore, that the distribution is a dividend within the meaning of section 201 (a).

It remains to be determined whether this distribution falls within the express exemption of section 201 (b), which provides in part:

Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913. . . . *but any earnings or profits accumulated prior to March 1, 1913,* may be distributed in stock dividends or otherwise, exempt from the tax, after earnings and profits accumulated since February 28, 1913, have been distributed.

This section, read in connection with the definition of a dividend makes manifest the intention of Congress to exempt "earnings and profits" which would otherwise be taxable under the doctrine of the Hornby case. It will be noted, however, that the statute is peculiarly silent as to the increase of capital assets accrued prior to March 1, 1913. At the time the Revenue Act of 1918 was passed by Congress

the case of *Lynch v. Hornby* had been decided and it must be assumed that Congress knew that under that decision increase of corporate assets as well as earnings and profits accumulated prior to March 1, 1913, but distributed later in the ordinary course, were taxable as income. Whatever may be conjectured as to the intention of Congress to reverse by statute the entire ruling laid down in the Hornby case, the fact remains that it did not use language which in our judgment is sufficient to accomplish that result, and it can not be assumed by an executive department that Congress intended to extend the exemption beyond the clear import of the words used. The express exemption applies to "earnings and profits" accumulated prior to March 1, 1913, and as has already been demonstrated, these terms do not include unearned increment. A distribution like that under consideration in this case is not, therefore, within the exemption.

For the reasons above stated it is concluded that profits made by a corporation in 1918 or subsequent years from the realization of appreciation of corporate assets accrued before March 1, 1913, is taxable income to the stockholder when distributed as a dividend in 1918 or subsequent years. (B. 43-21-1878, Oct. 26, 1921; L. O. 1073.)

The foregoing ruling, in the author's opinion, is erroneous. It is based upon the propositions (1) that the words "earnings and profits" do not embrace an increase in value of corporate assets while unconverted; (2) that immediately upon realization by sale or conversion after March 1, 1913, such increase becomes "earnings and profits *accumulated* after February 28, 1913"; and (3) that although it has accrued prior to March 1, 1913, it does not come within the saving provisions of section 201 (b). It is manifest that the Solicitor has indulged in some very fine-spun reasoning, and has given to the statute a very narrow interpretation, contrary to the well-settled rule that tax statutes must be construed strongly against the government and in favor of the citizen.[29]

If for argument it be conceded that the words "earnings and profits" do not embrace a mere "increase in value" until the latter is realized through sale or conversion, still there is no justification, especially under a statute which in case of doubt must be construed in favor of the taxpayer, for holding

[29] *Gould v. Gould,* 245 U. S. 151.

that the profit which has resulted from a sale or conversion was *"accumulated* since February 28, 1913."

The "profit" *as such,* it is true, has been realized since that date, but it has not *"accumulated"* since then. The word "accumulated" means "to bring together by degrees or successive additions."[30] There can be no accumulation, in the ordinary and proper sense of that word, when an increase in value is turned into a profit by the single act of sale or conversion. If the words "earnings and profits," as used in section 201, are to be given the meaning ascribed to them in the above ruling and the word "accumulated" its ordinary one, then the increase in value of corporate assets, when distributed among stockholders, may not be considered "a dividend" within the meaning of that section and hence is probably not taxable. This would apply to increases which have accrued subsequent to March 1, 1913, as well as prior thereto.

Such a construction would not, however, in the author's opinion, be proper because the various income tax acts have sought to tax both individuals and corporations on the increases in value arising after March 1, 1913, when realized through sale or conversion; and there is nothing to show that there was any intention on the part of Congress to exempt stockholders from the tax, except as set forth in section 201 (b). Nor is there anything to indicate that Congress proposed to exempt any dividends in the hands of individuals from the normal tax when the corporation was not subject to a tax on the moneys represented thereby. Yet that would be the result of the above ruling, because any increase in value, in so far as it is represented in the value as of March 1, 1913, is not, even after sale, an earning or profit which can be taxed against the corporation.

But it is thought that the act as a whole when considered in connection with the prior acts and the Act of 1921, repels the idea that any such narrow interpretation of the words

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[30] *Standard Dictionary.*

"earnings and profits" may be adopted as the Solicitor has indulged in. The Act of 1913 contained no exemption whatever. The 1916 and 1917 acts exempted dividends out of "earnings or profits accrued" prior to March 1, 1913. They were passed after decisions adverse to taxing dividends paid in the ordinary course of business after March 1, 1913, out of a surplus accumulated before that date, had been rendered by the District Court and the Circuit Court of Appeals in the *Hornby* case, but before the Supreme Court had rendered its decision to the contrary. The 1918 act was in all respects material to this question the same as the 1917 act.

The foregoing ruling was made after the first House draft of the 1921 act appeared. In the latter, the words of the exemption clause of section 201 (b) were, as in the 1918 act, "but any earnings or profits accumulated prior to March 1, 1913, may be distributed exempt from the tax." After the ruling was promulgated, the House draft was amended in the Senate by inserting after the word "accumulated" in the clause in question, "or increase in value of property accrued." Thus there is evidenced a clear and well-defined purpose or policy commencing in 1916 on the part of Congress to exempt from tax, dividends paid out of corporate assets accumulated before March 1, 1913. The fact that this change in the last law was made after a department ruling diametrically contrary thereto, is most convincing evidence that Congress intended in the 1918 act, that increases in value should be included in the words "earnings or profits accumulated," as used in section 201 (a) and (b). The reason for such a policy is to make the tax on dividends the same in principle as that assessed against other kinds of income, and to carry out the purpose, as announced in Congress, of the framers of the 1917 act to encourage the payment of dividends out of surplus (without distinction as to its source) accumulated after March 1, 1913. All of the acts since 1913 have exempted individuals and corporations from tax on appreciation in values of property up to March 1, 1913.

The reasonable conclusion, therefore, is that Congress in-

tended, by section 201, subdivisions (a) and (b), of the 1918 act, to exempt from tax such of the profits distributed by a corporation as represent increases in value which have accumulated before March 1, 1913, and which later have been realized by sale or conversion, as well as those which represent earnings and other profits.

The Solicitor states that section 213 defines "income" as including "profits," and goes on to say, "surely a part cannot be said to be greater than the whole as that whole has been defined by the Supreme Court." He fails to state that section 213 is a definition of gross—not net—income and that all of the items in section 213 are to be included in the taxable year. If section 213 is controlling and realization of appreciation prior to March 1, 1913, is a profit, it must be a taxable profit. But of course it is not. So with the Solicitor's other extracts from decisions and sections of the law. He makes the part greater than the whole. The law as a whole defines taxable income, taxable gains, taxable dividends. The designation of appreciation and surplus at March 1, 1913, has been capital uniformly *since the enactment of the 1916 law* (with which the *Hornby* case had nothing to do), and no part of that capital is to be taxed. The attempt to tax it in the hands of its beneficial owners is a clear disregard of the letter as well as the intention of the law.

Dealing specifically with the 1918 law, which forms the special burden of the Solicitor's opinion, it must surely be assumed that the different sections of the law which deal with the same subject or related parts of it were intended to be consistent and to give the same meaning to the same thing. Section 201 (a), in defining the term "dividends," deals with the "earnings or profits accumulated since February 28, 1913," by *a corporation.* Section 202 and sections 232-234 define the earnings or profits of *a corporation.* Section 202 states how "gain derived . . . . from the sale or other disposition of property" is to be computed; the section simply says "gain," *not* "taxable gain," though, of course, only gain computed in

accordance with this section is taxable. In the case of property acquired prior to March 1, 1913, the "gain derived" is only the realization in excess of the value at that date. Section 232 states how the "net income" of a corporation is to be computed, namely, by deducting from "gross income" as defined in section 233 the deductions permitted by section 234, section 234 provides that the deduction for depletion shall be on the basis of the value of the property at March 1, 1913.

Is it not obvious that in speaking of the earnings or profits of a corporation accumulated since February 28, 1913, they must be viewed in the light of the sections which define how gains and income of a corporation are to be computed, and that the exclusion of appreciation of property values accrued prior to March 1, 1913, in sections 202 and 234, requires a similar exclusion in section 201 (a)? The treatment of appreciation prior to March 1, 1913, in sections 202 and 234 automatically includes such appreciation in the "earnings or profits accumulated prior to March 1, 1913," which are referred to in section 201 (b).

Application of tax-free distributions in computing gains and losses.—The second sentence of section 201 (b) provides that in computing losses in final realization, prior tax-free distributions must be credited as partial returns of capital. Section 201 (c), on the contrary, provides that in computing gains in final realization, prior tax-free distributions may be ignored.

For illustrations see Chapter XXIX.

Distribution from proceeds of a claim at March 1, 1913.—The fact that what a corporation had at March 1, 1913, was capital and that payments out of capital are not taxable income, is clearly stated in a recent case,[81] decided under the 1916 law.

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[81] *Park v. Gilligan, Collector,* U. S. Dist. Ct., So. Dist. of Ohio, West Div., June 11, 1921 (not reported); see Corp. Tr. Co. 1921 *Income Tax Service,* 3067 *et seq.*

Decision. The item represented, therefore, the distribution of the proceeds of a chose in action arising *ex delicto* long prior to March 1, 1913. It was compensation for an injury which John D. Park & Sons Co. had suffered by reason of a violation of the anti-trust law. It was not in itself a profit, but was indemnification for a wrong which had caused a loss of profits. On March 1, 1913, it was represented by an accrued chose in action. On November 1, 1916, it was reduced to cash.

By the Act of 1913 dividends were taxable if paid after March 1, 1913, whether from profits theretofore accrued or thereafter. Lynch v. Hornby, 247 U. S. 339. . . . . But by the Act of 1916 taxable dividends were limited to those made out of earnings or profits accrued since March 1, 1913. And, I take it, whatever claims the corporation had upon that date, whether arising from profit or otherwise, are to be considered as capital then accrued, for the purposes of this act, and that profit since accrued means after-acquired gain, which did not then exist, and that the mere fact that a then existing claim, even though representing a profit, was afterwards collected, would not make it a profit accrued after the prescribed date. The same limitation was carried in the amendment of October 3, 1917, and substantially the same in Section 201 of the Act of 1918, the date being there changed to February 28, 1913. Any distribution of property or money accumulated by a corporation prior to March 1, 1913, has not been taxable as income at any time since the enactment of the Act of September 8, 1916. And it was under that act that the taxes in question were imposed. Therefore, the distribution of the sum realized from the compromise of the chose in action under discussion was not a dividend taxable as income unless that sum can be regarded as representing profit accrued after March 1, 1913.

The brief filed by the Government rests its contention upon the proposition that when a dividend is declared and paid by a corporation such dividend is presumed to have been paid from profits, and not from capital, and that if the value of the capital of this corporation, after the distribution of said sum of $85,000, was equal to its value of March 1, 1913, the distribution of the $85,000 was a distribution of the profits, and the shares received by the plaintiffs were taxable income. But the evidence is that all, or practically all, of the profits that accrued to this corporation between March 1, 1913, and January 1, 1917, were paid out in other dividends, and it was impossible that this $85,000 could have been paid out of earnings on hand. The corporate surplus was practically exhausted by the payment of such other dividends from year to year. Therefore, the presumption upon which the argument of the Government, as set forth in the brief, rests, to-wit, that this distribution was made from profits accumulated within the taxable period, is overcome by the evidence. The fact is that this asset, which had accrued and existed in the form of a chose

in action at and long prior to March 1, 1913, was on November 1, 1916, realized upon and distributed, and the corporate property as it stood at the former date was thereby diminished accordingly. There is no evidence that this chose in action was of any greater value on the latter date than it was on the former. Therefore, as this distribution was not out of profits accrued since the statutory date, it was not taxable to the distributees as income.

In the foregoing decision the court upholds the contentions of the author that under the 1916 and subsequent laws dividends paid out of capital at March 1, 1913, whether on the books or not, were not taxable, even though paid prior to January 1, 1921.

Rentals paid to stockholders.—In a recent case[32] the trustee in bankruptcy sought to deduct from the bankrupt's gross income as an expense of operation certain rentals for films which the Treasury claimed were a distribution of net profits. The bankrupt had contracted with ten manufacturers of moving picture films, each originally owning one-tenth of the bankrupt's common stock, whereby they were to lease to it their films at a certain sum per foot plus a payment at the end of the year, which payment was to be made from the bankrupt's net profits during the year in excess of a specified dividend on its stock. Since this additional payment was based entirely upon the amount of film footage each lessor had furnished the bankrupt during the year and had no reference to the stockholdings, it was held that these additional payments were properly deductible as additional rent and did not constitute an attempt to distribute surplus to stockholders.

Allocation of Dividends to Periods When Accumulated

No phase of the subject of income tax has demanded so much attention as the determination of the period to which dividend payments should be allocated. Dividends, for pur-

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[32] *In re General Film Corporation*, C. C. A., Second Circuit, 274 Fed. 903.

poses of allocation, under the 1921 law may be separated into four classes, *i. e.*, as paid from:

1. Earnings accumulated since February 28, 1913.
2. Earnings accumulated prior to March 1, 1913.
3. Appreciation in value at March 1, 1913.
4. Capital.

LAW. Section 201. . . . . (b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; . . . .

The following section of the 1921 law is a re-enactment of 201 (e) of the 1918 law, and is for the purpose of determining invested capital only, not for computing income taxes. It loses significance with the repeal of the excess profits tax.

LAW. Section 201. . . . . (f) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921.

The general regulation covering allocations reads in this manner:

REGULATION. (*a*) For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913;

(*b*) Every distribution made by a corporation during the first 60 days of a taxable year shall be deemed to have been made from earnings or profits accumulated during the preceding taxable years. Every distribution made during the remainder of the taxable year after the first 60 days shall be deemed to have been made from earnings or profits accumulated during the taxable year up to the date of the distribution to the extent of such earnings or profits. The pre-

sumptions contained in this paragraph affect the determination of invested capital for the purpose of the excess profits tax and are not in effect after December 31, 1921. They have no effect upon the rates at which dividends paid in 1921 and subsequent years are taxed. In ascertaining whether or not a distribution was made out of earnings or profits of the taxable year there should first be set aside a proper reserve for the payment of accrued income and excess profits taxes.[33] . . . .

In the case of a personal service corporation every distribution is made out of earnings or profits and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913. Such a distribution, if made during the first 60 days of a taxable year, shall be deemed to have been made from the most recently accumulated earnings or profits of preceding taxable years,[34] and if made during the remainder of the taxable year after the first 60 days, from earnings or profits accumulated during the taxable year up to the date of distribution to the extent of such earnings or profits. The presumption contained in the preceding sentence is not in effect after December 31, 1921. As stated in article 1541 the term "dividend" does not include a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922. (Art. 1542.)

The Treasury has gone to considerable length in explaining its position in regard to the manner of applying the rule laid down above. Apparently one of the first rulings on this subject was questioned and a subsequent ruling, quoted in part below, was issued.

Ruling. The word "accumulated," as used in the phrase "accumulated since February 28, 1913," in ruling 31-20-1098, O. D. 610, means, in the judgment of the Committee, profits which have been earned and not dissipated by subsequent losses. While it is recognized that assets can not be earmarked as representing earnings of any particular year, it is a fair assumption that the earliest surplus of a corporation is likely to be represented in its balance sheet by fixed assets, while the later earnings are more apt to be represented by liquid assets. Consequently any losses sustained in a given year will be met out of the most recent earnings embraced in its surplus. It follows that profits of any year can not be diminished by prior losses, but it is fair to assume that such earnings, to the extent necessary, will go to satisfy subsequent losses. There is no obliga-

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[33] See Appendix A, Chapter XI.

[34] See page 733.

tion to recognize for tax purposes the surplus of March 1, 1913, as capital which must be made good before there can be any distribution of profits. (C. B. 3, page 36; A. R. M. 82.)

In the detailed ruling the following illustration is given:

Earnings		Losses		Surplus	
Mar. 1 to Dec. 31/13	$10,000	Jan. 1/14 to Dec. 31/16	$25,000	Mar. 1/13 ..	$100,000
				Dec. 31/13.	110,000
Jan. 1 to Dec. 31/17	15,000			Dec. 31/16.	85,000
		Jan. 1 to Dec. 31/18	10,000	Dec. 31/17.	100,000
Jan. 1 to Dec. 31/19	5,000			Dec. 31/18.	90,000
				Dec. 31/19.	95,000
Jan. 1/20 to date of dividend..	15,000	Dividend, 1920.	$25,000		

The most recent loss shown is that of 1918. This, of course, was met out of earlier earnings and the corporation must have on hand at the present time the $5,000 earned in 1919 as well as the $15,000 earned in the current year. Of the $15,000 earned in 1917, $10,000 was lost in 1918, leaving it with $5,000 earnings of 1917 still on hand. The $15,000 of 1920 earnings, together with the $5,000 of 1919 earnings and the $5,000, remaining of 1917 earnings covers the dividend of $25,000, showing that all of the dividend was paid out of earnings accumulated since March 1, 1913, notwithstanding the fact that the company's surplus on December 31, 1919, was $5,000 less than it was on March 1, 1913. From this it might be argued that necessarily, since its surplus on December 31, 1919, was less than that of March 1, 1913, any distribution in excess of the earnings of 1920 must have come out of the March 1 surplus. This, however, is a fallacy since there is no obligation to recognize for tax purposes the surplus of March 1, 1913, as capital which must be made good before there can be any distribution of profits. . . . .

A corporation with a surplus of $100,000 on March 1, 1913, might have losses in alternate years up to 1923 aggregating $100,000 and profits in other years (all paid out in dividends) aggregating the same amount. The effect of the ruling would be that on January 1, 1923, it would have no surplus. The surplus at March 1, 1913, which was supposed to be free from tax, would in effect all have been taxed, although the dividends paid exactly exhausted that surplus.

If no dividends were paid, the corporation on January 1,

1923, would have a surplus of $100,000, all of which would be deemed to have been earned after March 1, 1913.

The foregoing ruling is seriously questioned in the following:[35]

In the supposititious case a corporation was in possession of a surplus of say $100,000, March 1, 1913. During the period ended December 31, 1919, it sustained a net loss of $5,000, thereby reducing its surplus to $95,000. It declared a dividend of $25,000 some time in 1920, during which year and up to date of which declaration its earnings are supposed to have been $15,000. Hence, under the most limited interpretation the corporation must have paid its dividend out of the $15,000 earned in 1920, and $10,000 out of its surplus earnings of March 1, 1913.

The department has ruled that because the corporation earned, say, $5,000 in 1919 and $15,000 in 1920, only $5,000 of the $25,000 dividend could be considered to have been paid out of the surplus of March 1, 1913. Truly a remarkable decision reached by a unique method of reasoning.

In the foregoing ruling the Treasury declines to recognize surplus at March 1, 1913, as capital, but in the following ruling dividends paid during the first 60 days of 1918, which under the law should have been applied first to earnings accumulated during preceding taxable years (note the plural), were taxed at the 1918 rates, on the ground that the years prior to 1913 were not taxable years.

In the latter case surplus at March 1, 1913, is treated as capital. In the former case the surplus at March 1, 1913, is treated as if it were taxable earnings. The rulings are not consistent and one of them must be erroneous. The author is of the opinion that the following ruling is sound and the one on page 729 is unsound.

Ruling. Where a corporation has profits accumulated prior to March 1, 1913, but none accumulated between that date and January 1, 1918, and pays dividends during the first 60 days of 1918, such dividends will be deemed to have been paid from earnings or profits accumulated after December 31, 1917. (C. B. 1, page 26; T. B. R. 43.)

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[35] *Journal of Accountancy*, Income Tax Department, November, 1920.

The definition of the word "accumulated" in A. R. M. 82 merely states that it means "profits which have been earned and not dissipated." The definition is not in accord with the ordinary meaning of the two words.

Effect of stock dividend on surplus at March 1, 1913.—

RULING. A corporation having a surplus accumulated in part prior and the remainder subsequent to March 1, 1913, transfers to its capital account a portion of its surplus and issues new stock representing the amount transferred, then declares a dividend payable partly in cash and partly in shares of the new issue, allocating the cash dividend to the period prior to March 1, 1913, and the stock issue to the period subsequent thereto.

Held, in view of section 201 of the Revenue Act of 1918, which provides that a distribution whether paid in cash or in other property is not a dividend for income tax purposes unless representing earnings accumulated since February 28, 1913, and the decision of the Supreme Court in *Eisner v. Macomber*, that a stock dividend issued as a result of the transfer of earnings accumulated subsequent to February 28, 1913, to capital account or other bookkeeping procedure equivalent thereto, is not a distribution which is taxable under the Revenue Act of 1918, or previous income tax statutes, that the portion of the dividend which is paid in cash will be deemed to have been paid out of surplus accumulated since February 28, 1913, to the extent of the earnings and profits accumulated since that date and subject to tax, while that portion of the dividend which is paid in stock will not be taxable as income. (Also arts. 1542 and 1545.) (C. B. 3, page 23; O. D. 587.)

The foregoing ruling is believed to accord with good accounting practice.

All cash dividends received after January 1, 1918, taxable at rates in force in period when received.[36]—Under both the 1918 and 1921 laws, all dividends (except stock dividends) are taxable to the recipients as income at the rates in force for the period during which the dividends are received, e.g., all cash dividends received in 1921 are taxable at 1921 surtax rates, and those received during 1922 at 1922 rates.[37]

[36] For former procedure as to all dividends taxable at rates of former years, see *Income Tax Procedure*, 1920, pages 485-487.

[37] Section 211 (a-2). For discussion regarding taxability of dividends on the basis of the year in which earned, see *Income Tax Procedure*, 1920, page 485, and *Income Tax Procedure*, 1921, page 575.

Status of dividends received during first sixty days of taxable year.—To clear up the difficulty of determining the period to which dividends should be charged for the purposes of the excess profits tax law, it has been arbitrarily decided that all dividends paid within sixty days after the close of a taxable year shall be assumed to have been declared out of earnings which accumulated during preceding taxable years. If a taxable year ended December 31, 1920, any dividend paid (no matter when declared) between January 1, and March 1, 1921 (both inclusive) would be deemed to have been out of the earnings which accumulated prior to January 1, 1921.[38] The amount of such dividend thereupon decreases the invested capital of the corporation from and after the date of payment.

If paid after March 1 the dividend will be deemed to have been paid out of 1921 earnings (to the extent of the earnings from January 1 to date of dividend payment), and the invested capital as of January 1, 1921, will not be decreased thereby. Like many other provisions which affect the excess profits tax, the rule in most cases works out fairly. The next dividend date after March 1 is usually April 1.

By April 1 there is usually opportunity to accumulate sufficient funds to pay the dividend of that date out of current earnings. But in very many cases dividends paid long after April 1 are deemed by the directors to be out of earnings of the previous calendar year.

As construed by the regulations in the case of ordinary corporations, the provision has no bearing on anything other than the excess profits tax, and consequently its consideration will be of no importance in making returns for calendar years ending after December 31, 1921.

SIXTY-DAY CLAUSE HAS NO REFERENCE TO RATES.[39]—

RULING. Cash dividends received during the first 60 days of 1918 are taxable at 1918 rates. (C. B. 2, page 25; A. R. R. 127.)

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[38] See ruling and comment, Appendix A, Chapter XI.

[39] For discussion of this question, see *Income Tax Procedure*, 1920, pages 461-2.

Cash dividends received during the first sixty days of 1921 and subsequent years are taxable at the rates of the years in which received (article 1542).

Local Taxes Paid on Bank Stocks No Longer Equivalent of Dividends

In addition to the cash dividends received from banks, the owners of some bank stocks have local taxes paid for their account by the banks. The amount of such payments is deductible by the bank[40] and does not form constructive income to the stockholder.[41]

Salaries in Excess of Reasonable or Necessary Allowances to be Treated as Dividends

As to the treatment of amounts ostensibly paid as compensation, the Treasury has issued the following regulation.

REGULATION. . . . . (1) In the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, the amount of the excess should be treated as dividends and would thus be exempt from the normal tax in the hands of the recipients. . . . . (Art. 106.)

Before the foregoing regulation can be applied, salaries must be found to be excessive. For a full discussion of salary allowances, see Chapter XXVI.

Dividends Paid Otherwise Than in Cash

REGULATION. Dividends paid in securities or other property (other than its own stock), in which the earnings of a corporation have been invested, are income to the recipients to the amount of the market value of such property when receivable by the stockholders. . . . . (Art. 1547. Reg. 45, Art. 1544.)

Most dividends are paid in cash or in stock, but occasionally distributions are made in some other form. When a divi-

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[40] Section 234 (a-3).

[41] Section 214 (a-3-d).

[Former Procedure] Under the 1918 and prior laws, taxes assessed on stockholdings and paid by banks on behalf of their stockholders, were considered as additional dividend to such stockholders, the latter in turn entering the taxes as a deduction in their personal returns.

dend other than cash or stock is received, it should be returned for taxation at its cash value. If its equivalent cash value cannot be ascertained at time of receipt it should be returned when and if cash value can be determined.

In the foregoing regulation no mention is made of any restriction upon the credit which may be taken for the normal tax. The law defines a dividend to be "any distribution made by a corporation . . . . out of its earnings or profits."[42] In one section of the 1918 law there is an indication that the credit for the normal tax is based upon and limited to the earnings or profits upon which income tax has been imposed.[43] It is logical and proper that a taxpayer should only receive credit for the normal tax upon an amount equal to the earnings which have paid the tax.

In the 1921 law, dividends from foreign corporations deriving 50 per cent or more of their gross income from *outside* the United States may not be credited for normal tax.

The courts have drawn a very fine distinction between dividends which are in final liquidation and those which are "recurring" or which leave the capital intact. In 1921 the Supreme Court of the United States decided several cases which must be deemed to be conclusive of these factors.[44]

When a dividend is paid in the stock of other companies, or in property, which has a fair market value, or a readily realizable value, *and* when the capital stock of the paying corporation remains unimpaired, the dividends are taxable as ordinary cash dividends.

The foregoing principles were affirmed in the cases of *United States v. Rockefeller,*[45] *New York Trust Company, et al. v. Edwards,*[46] and *United States v. Phellis.*[47] In these

[42] Section 201 (a).

[43] Section 216 (a), 1918 law.

[44] *Lynch v. Turrish,* 247 U. S. 221; 38 S. Ct. 537; 62 L. Ed. 1087; *Lynch v. Hornby,* 247 U. S. 339; 38 S. Ct. 543; 62 L. Ed. 1149; *Brushaber v. Union Pac. Ry. Co.,* 240 U. S. 1; 36 S. Ct. 236; 60 L. Ed. 493.

[45] 274 Fed. 952; affirmed November 21, 1921; advance opinions, 66 L. Ed. 74.

[46] 274 Fed. 952; affirmed; advance opinions, 66 L. Ed. 74.

[47] *U. S. v. Phellis,* advance opinions, 66 L. Ed. 69 (November 21, 1921).

cases dividends were paid in the stock of a pipe line company and in the stocks and securities of a powder company. In each case the securities had a known and realizable market value, and in each case the capital of the paying companies was unimpaired by the distributions. In other words, the court held that the dividends were paid from surplus. In each case values at March 1, 1913, were taken into consideration.

The court said in the *Rockefeller* case:

DECISION. . . . . The facts are in all essentials indistinguishable from those presented in *United States* v. *Phellis,* decided this day. In these cases as in that, regarding the general effect of the entire transactions resulting from the combined action of the mass of stockholders, there was apparently little but a reorganization and financial readjustment of the affairs of the companies concerned, here a subdivision of companies, without immediate effect upon the personnel of the stockholders, or much difference in the aggregate corporate activities or properties. As in the Phellis case, the adoption of the new arrangement did not of itself produce any increase of wealth to the stockholders, since whatever was gained by each in the value of his new pipe line stock was at the same moment withdrawn through a corresponding diminution of the value of his oil stock. Nevertheless the new stock represented assets of the oil companies standing in the place of the pipe line properties that before had constituted portions of their surplus assets, and it was capable of division among stockholders as the pipe line properties were not. The distribution, whatever its effect upon the aggregate interests of the mass of stockholders, constituted in the case of each individual a gain in the form of actual exchangeable assets transferred to him from the oil company for his separate use in partial realization of his former indivisible and contingent interest in the corporate surplus. It was in substance and effect, not merely in form, a dividend of profits by the corporation, and individual income to the stockholder. . . .

In the *Phellis* case the court said:

DECISION. . . . . After the reorganization and the distribution of the stock of the Delaware corporation, the New Jersey corporation continued as a going concern, and still exists, but except for the redemption of its outstanding bonds, the exchange of debenture stock for its preferred stock, and the holding of debenture stock to an amount equivalent to its own outstanding common and the collection and disposition of dividends thereon, it has done no business. It is not, however, in process of liquidation. . . .

Upon the face of things, however, the transfer of the old com-

pany's assets to the new company in exchange for the securities issued by the latter, and the distribution of those securities by the old company among its stockholders, changed the former situation materially. The common stock of the new company, after its transfer to the old company and prior to its distribution, constituted assets of the old company which it now held to represent its surplus of accumulated profits—still, however, a common fund in which the individual stockholders of the old company had no separate interest. But when this common stock was distributed among the common stockholders of the old company as a dividend, then at once—unless the two companies must be regarded as substantially identical—the individual stockholders of the old company, including claimant, received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit. Such a gain resulting from their ownership of stock in the old company and proceeding from it constituted individual income in the proper sense. . . . .

There is more force in the suggestion that, looking through and through the entire transaction out of which the distribution came, it was but a financial reorganization of the business as it stood before, without diminution of the aggregate assets or change in the general corporate objects and purposes, without change of personnel either in officers or stockholders, or change in the proportionate interest of any individual stockholder. The argument, in effect, is that there was no loss of essential identity on the part of the company, only a change of the legal habiliments in which the aggregate corporate interests were clothed, no substantial realization by individual stockholders out of the previous accumulation of corporate profits, merely a distribution of additional certificates indicating an increase in the value of their capital holdings. This brings into view the general effect of the combined action of the entire body of stockholders as a mass.

In such matters, what was done, rather than the design and purpose of the participants, should be the test. However, in this case there is no difference. The proposed plan was set out in a written communication from the president of the New Jersey corporation to the stockholders, a written assent signed by about 90 per cent of the stockholders, a written agreement made between the old company and the new, and a bill of sale made by the former to the latter, all of which are in the findings. The plan as thus proposed and adopted, and as carried out, involved the formation of a *new corporation*[48] to take over the business and the business assets of the old; it was to be and was formed under the laws of a *different State*, which nec-

[48] The italics here and those later on are the court's.

essarily imports a different measure of responsibility to the public, and presumably different rights between stockholders and company and between stockholders *inter sese*, than before. The articles of association of neither company is made to appear, but in favor of the asserted identity between the companies we will assume (contrary to the probabilities) that there was no significant difference here. But the new company was to have authorized capital stock aggregating $240,000,000—nearly four times the aggregate stock issues and funded debt of the old company—of which less than one-half ($118,515,900) was to be issued presently to the old company or its stockholders, leaving the future disposition of a majority of the authorized new issues still to be determined. There was no present change of officers or stockholders, but manifestly a continuation of identity in this respect depended upon continued unanimous consent or concurrent action of a multitude of individual stockholders actuated by motives and influences necessarily to some extent divergent. In the light of all this we can not regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company.

The findings show that it was intended to be established as such, and that it was so created in fact and in law. There is nothing to warrant us in treating this separateness as imaginary, unless the identity of the body of stockholders and the transfer *in solido* of the manufacturing business and assets from the old company to the new necessarily have that effect. But the identity of stockholders was but a temporary condition, subject to change at any moment at the option of any individual. As to the assets, the very fact of their transfer from one company to the other evidenced the actual separateness of the two companies. . . . .

. . . . There was neither express nor implied condition, arising out of the plan of reorganization or otherwise, to prevent any stockholder from selling it; and he could sell his entire portion or any of it without parting with his capital interest in the parent company, or affecting his proportionate relation to the interests of other stockholders. Whether he sold the new stock for money or retained it in preference, in either case when he received it he received as his separate property a part of the accumulated profits of the old company in which previously he had only a potential and contingent interest.

It thus appears that in substance and fact, as well as in appearance, the dividend received by claimant was a gain, a profit derived from his capital interest in the old company, not in liquidation of the capital but in distribution of accumulated profits of the company; something of exchangeable value produced by and proceeding from

his investment therein, severed from it and drawn by him for his separate use. Hence it constituted individual income within the meaning of the income tax law, as clearly as was the case in *Peabody* v. *Eisner*, 247 U. S. 347. . . . .

The court failed to state in the foregoing cases what its decision would have been if any one of the old companies had distributed all or part of their capital. Inferentially the use of italics would justify an inference that, if the capital of the old companies had been distributed, the substance of the transactions would have been that the stockholders received nothing in the way of taxable income, provided that the new securities were ratably issued to the old stockholders who thereafter merely owned what they had owned before the distribution and that there was a change in form only. In the *Phellis* case the court said:

DECISION. . . . . We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have under varying conditions followed the rule. *Lynch* v. *Turrish*, 247 U. S. 221; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71.

It would appear, therefore, that the court regarded the unimpairment of the capital of the old companies as a factor of substance.

Dividends paid in stock of another corporation.—

REGULATION. . . . . A dividend paid in stock of another corporation is not a stock dividend, even though the stock distributed was acquired through the transfer by the corporation declaring the dividend, of property to the corporation the stock of which is distributed as a dividend. Where a corporation declares a dividend payable in stock of another corporation, setting aside the stock to be so distributed and notifying the stockholders of its action, the income arising to the recipients of such stock is its market value at the time the dividend becomes payable. . . . .[49] (Art. 1547. Reg. 45, Art. 1544.)

[49] See Art. 53.

It will be noted that the rule of a "market value" is reiterated in this regulation.

A dividend paid in the stock of another corporation is treated as a cash dividend if the readily realizable market value can be determined. In such case the credit for the normal tax may be taken.

Dividends paid in Liberty bonds and other government securities.—Many corporations have paid dividends in the form of United States bonds.[50] Some stockholders formed the opinion that, because the income from the $3\frac{1}{2}$ per cent Liberty bonds was entirely tax-free, no tax would accrue to income received in the form of the bonds themselves. This view, of course, was erroneous because the tax is assessed against the receipt of the dividend and, so long as the dividend is received in cash or its equivalent, the tax should be levied. The case is precisely the same as if the corporation declared the dividend in cash and the stockholder purchased tax-free securities with the proceeds.[51] When Liberty bonds are selling at a discount, the tax can be assessed only on the cash value of the dividend.[52]

REGULATION. . . . . Although interest on State bonds and certain other obligations is not taxable when received by a corporation, upon amalgamation with the other funds of the corporation such income loses its identity and when distributed to stockholders in dividends is taxable to the same extent as other dividends. . . . . (Art. 1541.)

On its face it would appear that it is inequitable to assess stockholders for surtaxes on dividends which can be identified as having been paid out of funds derived from tax-free securities. As owners of the corporation the stockholders in effect own the tax-free securities and in theory should pay no tax whatever on the income therefrom. But the fact that the

[50] For opinion of the Attorney General of the United States on the taxability of dividends paid in tax-exempt bonds, see *Income Tax Procedure*, 1918, pages 154-156.

[51] Conversely, the corporation is permitted to take the loss. (C. B. 4, page 27; A. R. R. 435.)

[52] Letter from Deputy Commissioner L. F. Speer, November 12, 1918, and Art. 1547.

corporation and its stockholders are separate entities prevents the practical application of the theory. If the directors of a corporation desire its stockholders to receive the benefit of the exemption it will be necessary first to distribute the securities to the stockholders. After the distribution to individual stockholders the income will be entirely free from taxation.

Dividends paid in bonds which sell at a considerable discount should be entered by the recipients at the market value of the securities received. If the securities are subsequently sold at a lower price, credit may be claimed for the loss sustained. If sold at a higher price, the profit realized should be reported.

Dividends other than in cash are not closed and completed transactions when the property received has no "readily realizable market value." But the rule is of slight significance in the case of government bonds which are so nearly the equivalent of cash that fluctuations which may be only temporary can be disregarded.

Dividends paid in debenture bonds.—In ruling that dividends paid in debenture bonds were taxable, the court said:

DECISION. The plaintiffs received an actual payment (in the form of securities available for disposition in the market and entirely severed or distinguished from their control of the property as stockholders) of profits which the company wished to distribute as earnings to its stockholders.. . . .[53]

Scrip dividends.—

REGULATION. . . . . Scrip dividends are subject to tax in the year in which the warrants are issued. (Art. 1547. Reg. 45, Art. 1544.)

The rule of readily realizable market value is to be applied in this case also.

As scrip dividends are issued only by corporations unable

[53] *Doerschuck v. U. S.*, and *Thomas v. U. S.*, 274 Fed. 739, U. S. Dist. Ct., East. Dist. of N. Y., March 17, 1921.

to pay cash, the valuation of such scrip for tax purposes should be carefully considered.

Of course, if the scrip runs for a comparatively short period, as one or two years, if the rate of interest it bears is high enough and if the credit of the issuing corporation is good enough, then the recipient of the dividend might properly treat the scrip as a receipt of cash and return it accordingly. This, however, assumes that his books are kept on an accrual basis; otherwise when the scrip is redeemed in cash he may include it again.

For a person reporting on the basis of cash receipts, the safer method in the case of receipt of scrip of doubtful character or which has no active market would seem to be to wait until something more substantial is received than a "scrap of paper."

In the following ruling the principle of readily realizable market value and the equivalent of cash seems to be ignored:

RULING. The M Insurance Company issues certificates of profit based upon premiums received on marked-off risks of the previous year. These certificates mature in six years and are subject to the future losses and expenses of the company until redeemed and may be reduced by the board of trustees in the case of losses and expenses in any subsequent year exceeding the estimated profits of that year. Interest is payable annually upon the face value of the certificates.

Held, that the certificates are in the nature of scrip dividends in accordance with article 1544 of Regulations 45, and are taxable at the rate for the year in which declared or issued to the extent that they represent undistributed earnings or accumulated profits. Inasmuch as they are affected by the gains or losses of the company during their maturing period, the amount of such gain or loss should be accounted for in the taxable year in which the certificates mature or are redeemed.

The amount of interest annually payable on these certificates is taxable income for the year in which it is received. (C. B. 3, page 37; O. D. 589.)

If the certificates mentioned above are readily convertible into cash the market or discounted value thereof would seem to be the proper basis of the return.

Part of stock dividend paid in scrip.—

Ruling. A corporation declared a dividend payable in stock of the company at par and in making the distribution of fractions of shares issued scrip certificates. These scrip certificates at the option of the stockholders were sold by the corporation as agent for the stockholders.

Held, that the scrip certificates do not represent a cash dividend but a stock dividend and are therefore not subject to tax. (C. B. 4, page 24; O. D. 859.)

The profit on the scrip certificates sold would have to be computed as in the case of any other stock dividends.[54]

Scrip dividends redeemable in cash or stock.—When scrip dividends give an option to the recipient to redeem the scrip in cash or stock, the question arises as to whether or not they are stock dividends, and therefore not taxable, particularly when the stock has a market value considerably above the amount payable in cash. When they are issued no liability is created, the only entries in the books being a debit to surplus and a credit to "scrip dividend payable." Therefore no tax can be imposed at that point, because no asset of any kind has been segregated or distributed. It is, in effect, merely a suspense account. If any stockholder takes cash, there is to that extent only a diminution of assets and a distribution. When all stockholders take stock there is no distribution, but there is a transfer from surplus to capital, and all the elements of a stock dividend are present.

Cash Dividends, the Taxability of which Has Been Questioned

Dividends declared from depreciation and depletion reserves.—During 1917 certain corporations, particularly copper mining corporations, adopted a policy of declaring special dividends which were described as return of capital and not a distribution of profits. As such distributions were charged

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[54] See page 770.

to depletion reserves on the corporation's books, it was claimed that the surplus and undivided profits were not affected thereby and for this reason no tax could be assessed on the so-called dividends.

REGULATION. A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or depreciation reserve based upon the cost of the property will not be considered as having been paid out of earnings or profits, but the amount thereof shall be applied against and reduce the cost, or other basis, of the stock upon which declared for the purpose of determining the gain or loss from the subsequent sale of the stock. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings or profits, but the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon. No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed. (Art. 1546.)

The foregoing regulation differs from the corresponding one under the 1918 law (Regulations 45, article 1549)[55] in

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[55] **[Former Procedure]** The first ruling of the Treasury held that dividends out of depletion reserves were not taxable, as indicated by the following:

RULING. "Receipt is acknowledged of your letter of July 3, 1917, and in reply you are advised that, as may be seen upon reference to Treasury Decision 2481, the federal income tax law of September 8, 1916, authorizes corporations, joint-stock companies, etc., when making annual income tax returns, to deduct from gross income a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade, and in the case of oil and gas wells and mines, a reasonable allowance for depletion of natural products.

"You are further advised that when such deductions are made and their amounts are carried to a reserve account, and later a dividend is declared and paid from that account, the amount of the dividend is held to represent a return of capital invested, and it is not subject to income tax in the hands of the shareholders." (Letter to Henry W. Beal, Boston, signed by Deputy Commissioner L F. Speer and dated July 14, 1917.)

which a distribution from a depletion reserve is called a "liquidating dividend." It is clear, however, that after all profits accumulated since March 1, 1913, are distributed, a dividend from depletion reserve is:

1. A return of capital.
2. A reduction of the cost or March 1, 1913, value of the shares of stock.

A corporation should not be permitted to declare dividends out of capital so long as a surplus exists on the books. If no surplus exists, a distribution of capital should be coincident with a reduction in the capital stock of the corporation. Reserves are created for the purpose of keeping the capital intact, and any diminution of such reserves automatically reduces the capital. This should not be done unless stockholders can be depended upon to grasp the significance of the transaction. It is not likely that an ordinary stockholder who received a dividend described as having been charged to a depletion reserve would comprehend that it represented a distribution of capital. He would retain his stock certificate and would not be notified that the par value had been reduced. It is most likely that he would report the dividend for taxation with other dividends.

Certain corporations have notified their stockholders that parts of the dividends were from depletion reserves. Stockholders of such corporations may naturally assume that the earned surplus of the corporations has been exhausted and that the dividends are in fact out of depletion reserves. When such dividends are received they should be entered by the recipients as receipts of capital and should not be reported as taxable dividends.

The ruling quoted in footnote on previous page was revoked by T. D. 2540 (October 10, 1917).

REGULATION. "A distribution from such a reserve will be considered a liquidating dividend and will constitute taxable income to a stockholder only to the extent that the amount so received is in excess of the cost or fair market value as of March 1, 1913, of his shares of stock. . . . ." (Reg. 45, Art. 1549.)

Even though appreciation at March 1, 1913, has not been realized through sale, or through depletion charges,[56] tax-free distributions may be made therefrom, provided, of course, earnings since March 1, 1913, have all been distributed.

Dividends paid out of appreciation of goodwill.—The author does not care to assume that cash dividends would ever be paid out of surplus arising from appreciation in the value of goodwill or other capital assets. But since stock dividends are sometimes paid out of marked-up assets, no doubt some corporations will attempt to pay cash dividends from the same source.[57] If the stockholder were to receive a dividend accompanied by a notice from the corporation that it was in fact from surplus so created the stockholder should enter the dividend as free from tax. Appreciation accrued after March 1, 1913, is taxable when realized, but in the case cited it should be specifically stated that realization had not taken place. The dividend, in fact, would be out of capital and would not be taxable. The stockholder would be entitled to assume that the earned surplus of the corporation had been exhausted.

Dividends from capital surplus.—The regulations are clear that no tax will be imposed upon a dividend paid from capital surplus.[58] Capital surplus may arise through the payment by stockholders of an amount in excess of the par value of capital stock, through appreciation set up on the books as an asset, through the creation of shares of "no par" value and in other ways.

It is sometimes claimed that distributions similar to the foregoing may be made at any time irrespective of whether or not the surplus earned since March 1, 1913, has been distributed.

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[56] See pages 718-725.
[57] See Chapter XXIII, "Stock Dividends."
[58] Art. 1543, page 716.

Obviously the distribution of capital dividends diminishes the assets of a corporation to exactly the same extent as when a distribution of earnings is made. This question then arises: Is a provision of law enforceable which forbids any distribution until distribution is made of surplus earned since March 1, 1913? Section 201 (b) reads:

LAW. Section 201. . . . . (b) . . . . every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. . . . .

The author is of the opinion that this provision of the law is enforceable except when the distributions consist of payments required by the reduction or cancellation of capital stock.

When a corporation reduces its capital stock state corporation laws require that the stock certificates shall be canceled or stamped, and it would be illegal for a corporation to advise its stockholders that payments in reduction or retirement of capital stock should be deemed to be dividends out of recent earnings, merely because of a federal law which attempts to require a distribution of current earnings before previous earnings are distributed.

As a matter of fact payments in reduction of capital stock may be made to only one of several classes of stockholders. In many cases the obligations to retire preferred stock[59] are contractual and the payments must be made if the corporations are in funds.

This view has been accepted by the Treasury.

RULING. The term "distribution" as used in Section 201 (*b*) of the Act means the delivery or transfer of property by a corporation to its stockholders. Whether any distribution by a corporation

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[59] For discussion of redemption of stock held to be equivalent of a cash dividend [section 201 (d)], see page 764.

is to be deemed to have been made from earnings or profits depends upon the facts in each case. However, the term "distribution" as used in Section 201 (*b*) of the statute does not contemplate the payments made by a corporation to its stockholders in retiring its own stock if the liquidation of the stock was in pursuance of an obligation arising out of the stock contract, unless it appears that the corporation had the option of distributing its assets with a credit to capital stock account or to surplus account. However, inasmuch as a retirement of capital stock would indicate that additional capital was not required, any retirement of common stock, leaving the surplus stand, would be regarded by this office as making the corporation one coming within the provisions of Section 220 of the Revenue Act of 1918.[60] (C. B. 2, page 25; O. D. 360.)

The foregoing rule may not be applicable when the distribution to stockholders consists of the return by a corporation of a special or temporary assessment on its stockholders which is specifically returned when the emergency is over.

Liquidating Dividends

The 1921 law makes no specific reference to distributions in liquidation. Section 201 (c) of the 1918 law which provided that "amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock," appeared in the House draft of the 1921 law but was stricken out in the Senate. The new subsection (c) which was inserted in conference reads:

Law. Section 201. . . . . **(c) Any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee. . . . .**

Whatever the reason for eliminating specific reference to the liquidation of a corporation, it is clear from the foregoing section of the 1921 law that *any* distribution out of

[60] See Chapter XXXV, "Tax on Undistributed Profits of Corporations."

earnings accumulated since March 1, 1913, is a dividend. If not clear in subsection (c), there is nothing ambiguous in subsection (a) which provides that the term dividend "means any distribution made in cash or in other property, out of its earnings or profits accumulated since February 28, 1913." It is probable that the narrow construction placed by the Treasury upon section 201 (c) of the 1918 law is responsible for the change. That section was construed to mean that the credit for normal tax could not be taken in distributions in liquidation.[61] In the author's opinion the 1918 law did not so state and there certainly was no intention to deprive stockholders of the credit.

Distributions which are dividends.—As heretofore stated, dividends include *any* distribution out of earnings accumulated since March 1, 1913. There is not a word in any section of the law which contradicts this statement in section 201 (a). A distribution may be final or partial. The section contemplates final distributions in its reference to distributions in property other than cash.

Regulation. Where a corporation distributes all of its property in complete liquidation or dissolution, the gain realized by the stockholder from the transaction, computed under section 202, is taxable as a dividend to the extent that it is paid out of earnings or profits of the corporation accumulated since February 28, 1913. If the amount received by the stockholder in liquidation is less than the cost or other basis of the stock, a deductible loss is sustained. (Art. 1545.)

Therefore, the right to credit the normal tax is perfectly clear.

In computing excess profits tax in 1917 the Treasury held that liquidation dividends were dividends, and could be "credited" as ordinary dividends.

Taxable status of liquidation dividends.—The term "dividend" as used in section 201 (a) may be limited to dis-

[61] See page 751.

tributions made from earnings accumulated since February 28, 1913. Corporations have paid the normal tax on these earnings. Stockholders are liable for the surtax.

Distributions which are not dividends.—In view of the limitation on the term "dividend" in section 201 (a), it is obvious that all distributions, otherwise than out of earnings accumulated since March 1, 1913, are returns of capital, either taxable or not taxable according to their nature.

REGULATION. Any distribution made by a corporation to its stockholders otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, is not a dividend and is not taxable to the recipient. Any such distribution, however, shall be applied against and reduce the cost, or other basis, of the stock upon which declared, for the purpose of determining the gain or loss from the subsequent sale of the stock.

Example.—A purchased certain stock in 1915 for $10,000 and received in 1921 a distribution thereon of $2,000 paid by the corporation otherwise than out of its earnings or profits or the increase in value of property accrued prior to March 1, 1913. This distribution does not constitute taxable income to A. If A subsequently sells the stock the difference between the amount realized therefor and $8,000 is taxable gain or deductible loss, as the case may be. (Art. 1544.)

The foregoing regulation properly intimates that distributions out of earnings accumulated since March 1, 1913, are dividends. It also intimates that distributions out of earnings or increase in value of property accrued prior to March 1, 1913, may be dividends. As the latter distributions are not taxable in any event, it should be immaterial how they are designated.[62] The stipulation that distributions which are not dividends shall be applied to reduce the cost, or March 1, 1913, value, of the stock upon which declared is proper. It is equivalent to stating that such cost or value shall be reduced by the receipt of any distribution of capital which the corporation may make.

TAXABLE STATUS OF DISTRIBUTIONS WHICH ARE NOT DIVIDENDS.—Naturally any distributions of capital are free from

[62] It does make a difference, however. See page 748.

normal or surtaxes, unless and until there is a taxable net gain, in which case the gain is taxable as any other net gain, viz., if the stock is held for more than two years the maximum tax is 12½ per cent;[63] if held for less than two years the gain is subject to the full surtax rates.

Under the 1918 law it was the duty of the directors to distribute the assets in such a way that all earnings subsequent to March 1, 1913, should first be distributed formally as dividends. Distributions of surplus and appreciation at March 1, 1913, should first have been made and finally the capital returned. The last noted distribution was taxable or not taxable under section 201 (c) and article 1544.

Liquidating dividends under the 1918 law.—The 1918 law contained this specific provision:

LAW. Section 201. . . . . (c) Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares and any gain or profit realized thereby shall be taxed to the distributee as other gains or losses. . . . .

It was a new provision and was intended to set up an equitable basis for the taxation of distributions in liquidation. It was not intended as a substitute for the sections which governed the distributions of earnings accumulated since March 1, 1913. It was not intended as a penalty clause nor as imposing double taxation. The Treasury, however, construed it as an inclusive pronouncement that in connection with the liquidation of a corporation there could be no such thing as a dividend. The position was not justified by the language of the law; on the contrary it was inconsistent with the clear meaning of several other sections. In its administration there were difficulties which were caused by the unwarranted construction placed upon section 201 (c) rather than by the facts.

REGULATION. So-called liquidation or dissolution dividends are not dividends within the meaning of the statute, and amounts so distributed, whether or not including any surplus earned since February

[63] See page 627.

28, 1913, are to be regarded as payments for the stock of the dissolved corporation. Any excess so received over the cost of his stock to the stockholder, or over its fair market value as of March 1, 1913, if acquired prior thereto, is a taxable profit. A distribution in liquidation of the assets and business of a corporation, which is a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation, is distinguishable from a dividend paid by a going corporation out of current earnings or accumulated surplus when declared by the directors in their discretion, which is in the nature of a recurrent return upon the stock. (Reg. 45, Art. 1548.)

The following case is typical of an average dissolution. Usually there are several distributions.

RULING. In May, 1917, a corporation declared a dividend out of surplus profits earned during the three years immediately preceding, a distribution being made accordingly in 1917. In July of the same year, at a meeting of the board of directors, a sale of the real estate owned by the company was authorized and in February, 1918, the stockholders agreed that the capital stock should be returned to them according to the number of shares they held on that date and that all other assets of the corporation be distributed and paid as dividends.

Held, that the dividends received in 1917 should be treated as a distribution of earnings or profits accumulated subsequent to March 1, 1913, and subject to tax in the hands of the stockholders as provided in section 31 of the Revenue Act of 1917, but that the entire amounts distributed as a single and final dividend in 1918, including both capital and surplus, should be treated as the proceeds of a liquidation. (B. Digest 47-20-1309; A. R. M. 93.)

As a matter of fact, the distribution in May, 1917, was just as much part of a final distribution as that made in February, 1918. The law reads "amounts distributed in the liquidation." Surely the distribution in May, 1917, was "in" (not out) of the distribution.

In the following ruling the Treasury apparently reversed its position that a liquidating dividend was to be applied against the cost of the stock and any excess would be subject to both normal and surtax. Only the "return of capital" is applied against the cost.

RULING. Each and every distribution made by the corporation to its stockholders during the taxable year will be deemed to have

been made from earnings or profits of the corporation to the extent that the corporation had such earnings and profits on hand at the time the distribution was made. Any distribution in excess of the earnings and profits of the corporation on hand at the date of distribution represents a return of capital to the stockholders, and if such return of capital added to any amounts of capital previously returned to the stockholders does not equal the cost to them of their stock it will not be subject to either the normal tax or surtax in their hands. If at the time of any distribution the stockholders had received a return of capital in an amount equal to the cost of their stock, the entire amount distributed to them in excess of the earnings and profits of the corporation on hand at the date of distribution represents taxable income to them subject to both normal tax and surtax at the rates for the taxable year. In case of the subsequent liquidation of the corporation or the sale by the stockholders of their stock upon which they have had any return of capital, the amount so returned to them must be added to the amount received in liquidation or to the selling price, as the case may be, for the purpose of determining the gain or loss arising to them from the transaction. (C. B. 4, page 44; O. D. 955.)

In a subsequent ruling (Bulletin 36-21-1797; Sol. Op. 115) the Treasury returned to its former position of subjecting liquidating dividends to both normal and surtax.

Liquidating dividends under 1917 and prior laws.—As the 1918 law is the only one which contains any reference to distributions in liquidation, as distinguished from any other kind of distribution, we are compelled under the 1913, 1916, 1917 laws, as well as under the 1921 law, to depend on the laws themselves for guidance. In the 1917 law there was a clearly defined method prescribed for all ordinary and extraordinary dividends.[64] When a corporation was dissolved and its assets were distributed, they were taxable as dividends or as gains, depending on circumstances. In the absence of special statutes, words must be given their usual significance. Therefore the use of the word "dividends" in 1917 and prior laws included dividends in dissolution or liquidation as well as ordinary dividends.

[64] For dividends allocated to and taxed at the rates in force in prior years, see *Income Tax Procedure*, 1918, pages 136, 145.

The Supreme Court of the United States passed upon this very point in two decisions handed down the same day. The cases are *Lynch v. Turrish*[65] and *Lynch v. Hornby*,[66] decided June 3, 1918. In the *Turrish* case the court held that a dividend in dissolution was not taxable; and in the *Hornby* case the court decided that a dividend was taxable. In both cases the dividends were from earnings or gains accumulated prior to March 1, 1913. In the *Turrish* case, even though there was a final and complete distribution, the court always referred to the distribution as a dividend. The Commissioner assessed the tax on the theory that it was "a dividend received from a domestic corporation" and taxable as an ordinary dividend. The court held that no taxable income arose from the receipt of the dividend. Reference was made to the fact that a stockholder has no title to the property of a corporation "prior to a dividend being declared."

It is obvious that prior to the enactment of the 1918 law no one questioned the fact that a dividend in liquidation was a "dividend." There were serious questions regarding the taxable status of values at March 1, 1913, and the position of stockholders who purchase at a high price and who might pay excessive taxes upon a dividend in partial liquidation. But these questions never arose regarding the distribution of earnings accumulated *since* March 1, 1913. In the case of new stockholders who pay excessive taxes on partial liquidations, *because they are deemed to be ordinary dividends,* the United States Supreme Court in the case of *United States v. Phellis*[67] said:

Decision. The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital

[65] 247 U. S. 219.
[66] 247 U. S. 338.
[67] Advance opinions, 66 L. Ed. 69.

plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes in this as in other respects of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question wherher a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

Under section 202 (c) and (e)[65] of the 1921 law, there is no doubt that upon a reduction in capital stock, or an exchange of shares for shares and cash in a "reorganization," the cash is to be applied in reduction of the cost of the original shares.

Deferred dividends and redemption of preferred stock.—

Ruling. In 1919 a corporation paid three deferred dividends on its outstanding issue of first preferred stock and at the same time redeemed the entire issue of such stock at a premium of 12½ per cent. It is stated that the dividends so paid were those due February 1 and August 1, 1910, and February 1, 1911; that the actual surplus necessary to pay them was accumulated prior to December 31, 1911; that there had not been any actual declaration of these dividends prior to 1919 for the reason that the terms of issue of the stock prescribed when the dividends became due, the company merely having the privilege of deferring payment and that it was the understanding of the officers of the company that its surplus was held to pay past due dividends. The stock certificates contained a provision in accordance with which the deferred dividends were paid and the stock redeemed.

The three deferred dividends will be considered to have been paid out of earnings and profits accumulated since February 28, 1913, as provided for in section 201 (a) and (b), Revenue Act of 1918, unless it can be shown that all earnings and profits accumulated since that date were first distributed. If it can not be shown that

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[65] See pages 535 and 592.

the earnings and profits accumulated since February 28, 1913, were first distributed, the distribution constitutes income to the recipient stockholders subject to additional tax at the graduated rates, but not to the normal tax.

The payment in redemption of the stock was a distribution in part liquidation of the corporation within the meaning of section 201 (c), and not a dividend as defined in section 201 (a) of the act. The amount received by each stockholder in excess of the cost of his shares of stock to him or their fair market value as of March 1, 1913, if acquired prior to that date, represented taxable income to him, subject to both normal and additional tax. (C. B. 2, page 29; O. D. 488.)

The last paragraph of the foregoing ruling is probably unsound under the 1918 law and would not be applicable under the 1921 law. Assume a corporation has:

Common stock	$150,000
Preferred stock	100,000
Surplus (accumulated since March 1, 1913)	80,000

In 1921 the entire preferred stock was redeemed at a premium of 12½ per cent. The charge to surplus would be $12,500, as distribution from "earnings or profits accumulated since February 28, 1913"; thus coming within the definition of a "dividend"[69] which is exempt from normal tax.

Dividends of uncertain character.—Corporate officers should ascertain the exact status of funds from which dividends are paid before sending out dividend cheques. Vague statements as to the source of funds are confusing to the recipients and lay the corporation open to just criticism for not finding out in advance whether or not the dividend is taxable. One dividend notice read:

> Of the $1,600,000 which we declared January 10, 1919, as accumulated dividends on the second preferred stock, $427,347.18, or 26.7 per cent of the total, was out of 1918 earnings, and the balance, $1,172,652.82, or 73.3 per cent, out of the earnings of 1917.

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[69] Section 201 (b). See page 716.

Such a wording puts a stockholder on notice that there may be a measure of non-taxability in the dividend. In the case cited the dividend would be fully taxable because it made no difference when the earnings were accumulated. There was no excuse for sending out such a misleading notice.

Another notice sent out early in 1919 was as follows:

NOTICE TO STOCKHOLDERS:

The federal income tax law provides that the term "dividends" as used in the law, means any distribution made by a corporation "out of its earnings or profits."

All the distributions made by this company during the year 1918 are considered by the company to have been made *not* out of "earnings or profits," but out of capital, as the charges for depletion and depreciation for the year 1918, were in excess of the operating profits for the year. The company assumes no responsibility for the correctness of this opinion.

As the company which sent out the foregoing notice was a large one, it would have better served the interests of its stockholders if it had secured and included a good legal opinion, thus giving the stockholders something affirmative to work on, instead of scaring them by disclaiming all responsibility.

The notice should state whether the dividend is paid from:

1. Earnings accumulated since February 28, 1913.
2. Earnings accumulated before March 1, 1913.
3. Appreciation at March 1, 1913.
4. Capital (in reduction of capital stock).

If from (1), the dividend is subject to surtax only; if from (2) or (3), or both, the dividend is "tax-free," but will reduce the cost or March 1, 1913, value in case of sale of the shares at a loss. If from (4), the "dividend" is not subject to tax, but reduces the cost or March 1, 1913, value of the shares in case of sale, whether a gain or a loss is made.

Dividends on life insurance policies.—So-called dividends declared by life insurance companies on certain classes of un-

matured policies are in fact reductions of premiums and are not taxable. As a rule policyholders deduct the amounts of such so-called dividends from the premiums payable, but even if dividends are drawn in cash by the insured, such items, unless received on paid-up policies, do not constitute taxable income and should be excluded from returns.

REGULATION. . . . . Distributions on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. (Art. 47.)

DIVIDENDS ON TONTINE POLICIES.—

RULING. A taxpayer took out an insurance policy on the tontine plan in 1902 and in 1917 received the total accumulated dividends. The face value of the policy will be paid to him in 1922, if living.

Held, that the amount received in 1917 was not required to be reported as income for that year. The excess of the amount received at maturity of the policy plus all dividends received thereon, over the total premiums paid prior to March 1, 1913, or the cash surrender value of the policy as of that date, whichever is greater, plus the premiums paid subsequent to March 1, 1913, will represent taxable income to be reported for the year in which received for both normal and additional tax purposes. (C. B. 2, page 85; O. D. 490.)

So-called dividends which are in fact refunds are not taxable.—The word "dividend" is often carelessly used. Therefore, the recipient of a dividend (or what purports to be a dividend) from an unusual source should ascertain the source from which it is derived before returning it for taxation. The income tax is not imposed on refunds which are merely repayments of excessive prices paid for goods purchased, etc.

REGULATION. . . . . rebates made to purchasers, whether or not members of the association, in proportion to their purchases may be excluded from gross income in computing the net income subject to tax. Any profits made from non-members and distributed to members in the guise of rebates are, of course, subject to tax. (Reg. 45, Art. 522.)

Premiums received from a corporation on its capital stock are equivalent of dividends.—Many issues of preferred stocks

contain provisions compelling the retirement or purchase thereof by the issuing corporations at substantial premiums above par value. When corporations acquire shares of their capital stock in this manner the payments must be charged to surplus and cannot be treated as allowable deductions. The payments are clearly distributions of surplus or profits[70] and the normal income tax having been paid thereon by the corporations, the stockholders are not required again to pay the normal tax.

In reporting premiums for income tax purposes stockholders should enter the amounts precisely as if a dividend had been received.

If the earned surplus were not sufficient to pay the premiums, and the funds were derived from capital surplus or from gifts to the corporation by holders of common stock, the recipients could not claim credit for the normal tax. In the absence of advices to the contrary it may be assumed that the premiums represent a distribution of earnings. Corporations which have no surplus are rarely able to carry out the redemption provisions of a preferred stock issue.

Under the 1921 law such distributions are clearly dividends.[71]

Dividends in kind.—Article 1570 states that when a partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property. No mention is made of "dividends in kind" by corporations.[72]

A dividend in kind, generally speaking, means a distribution of taxable assets which cannot readily be turned into money, or which the stockholders or directors do not desire to turn into money.

A stock dividend is not a dividend in kind. When a corporation distributes to its stockholders the stock of another

[70] The term "dividend" means any distribution made by a corporation out of its earnings or profits. [1921 law, section 201 (a).]

[71] C. B. 2, page 29; O. D. 488. See page 755.

[72] [Former Procedure] Art. 1566, Reg. 45 (April 17, 1919 edition), provided for distributions in kind by corporations but the provision was eliminated by T. D. 2924 (September 26, 1919).

company it is a dividend in kind. If the stock so distributed has a fair market value the dividend is taxable. If it does not have a fair market value it is not taxable until realized.

There have been some so-called distributions in kind which should be held to be taxable.

A corporation sells its capital assets for cash, invests the proceeds in marketable securities and divides the securities among its stockholders. This is simply a dividend payable in securities and is taxable,[73] even though, technically, it is a dividend in kind.

A corporation buys a plot of land and holds it for some years. No sales are made and no fair market price is ascertainable. The corporation dissolves and conveys the land pro rata to its stockholders. This is a distribution in kind and no tax can be imposed until the stockholders dispose of their holdings, in whole or in part.

The foregoing illustrations are of clear cases—one immediately taxable and the other not. Between the two there are cases not so easy to decide. Whether or not the dividend is presently taxable depends largely on two factors: (1) When were the assets divided in kind acquired? (2) Is there any fair market value for the assets distributed?

Dividends Received by Corporations

The 1921 law has two new features in respect of dividends received by corporation.

LAW. Section 234. **(a) That in computing the net income . . . . there shall be allowed as deductions. . . . .**

(6) The amount received as dividends (a) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (b) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corpora-

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[73] See page 734.

tion has been in existence) was derived from sources within the United States as determined under section 217; . . . .

It imposes no tax on dividends received by one corporation from another corporation unless received from

(a) A domestic corporation receiving most of its income from within a possession of the United States.

(b) A foreign corporation deriving 50 per cent or more of its income from without the United States under certain conditions.[74]

Dividends other than (a) and (b) are to be included in gross income, but the full amount may be deducted in ascertaining net income.

It is now recognized that it is not equitable to impose tax on dividends received by a corporation, because the normal tax has already been paid on the earnings so distributed. Furthermore, when a corporation, which has received dividends, in turn pays out its own net income in dividends, the recipients (if individuals) are subject to the surtax. Therefore, any income tax assessed against dividends received by corporations is double taxation. The 1913, 1916 and 1917 laws all imposed expressly or by implication full or partial income taxes upon dividends received by corporations, but the 1918 law granted full credit for dividends received in determining the taxes payable by the receiving corporation.[75]

The 1921 law has placed a limitation on the full credit [section 234 (a-6)].

Dividends (received by corporations) which are not taxable.—Under the 1916, 1917, 1918 and 1921 laws, dividends payable out of surplus accrued prior to March 1, 1913, are not taxable. This provision applies to corporations as well as to individuals.[76]

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[74] Section 234 (a-6). See page 760.

[75] **[Former Procedure]** For regulations and procedure under former laws see *Income Tax Procedure,* 1919, pages 344-347.

[76] Section 201 (a).

Under the 1913 law, the Supreme Court has held that dividends received prior to December 31, 1915, are taxable even though paid out of surplus accrued prior to March 1, 1913,[77] but in a ruling case an exception was made to the rule.[78] The departure from the rule was justified by the court on the ground that the holding company was in actual possession and control of the funds represented by dividends prior to March 1, 1913, and that the declaration of the dividends after March 1, 1913, merely resulted in bookkeeping entries, there being no transfer of cash or property nor in fact any change in actual status. As stated by the court, "the payment was only constructive."

In a later case[79] the Supreme Court again decided that a dividend paid out of surplus accrued prior to March 1, 1913, was not taxable, on the ground "that the transaction should be regarded as bookkeeping rather than as dividends declared and paid in the ordinary course by a corporation."

A holding company acquired all of the stock of a subsidiary. The subsidiary then paid its entire surplus to the holding company as a dividend. The Treasury held:

RULING. A cash dividend paid in 1916 by a subsidiary to parent corporation, its sole stockholder, is taxable under the Revenue Act of 1916 to the extent that such dividend was paid from surplus earned after March 1, 1913 (1916 law only). (C. B. 1, page 19; T. B. R. 45.)

[77] *Lynch v. Hornby*, 247 U. S. 338 (June, 1918).

[78] *Southern Pacific Company v. Lowe*, 247 U. S. 330 (June, 1918).

[79] *Gulf Oil Corporation v. Lewellyn*, 248 U. S. 71 (December 9, 1918). See also *Park v. Gilligan*, U. S. Dist. Ct., So. Dist. of Ohio, West. Div., June 11, 1921 (1916 Act).

CHAPTER XXIII

INCOME FROM STOCK DIVIDENDS

The Supreme Court of the United States has decided that stock dividends are not taxable as income.[1] There are those who still believe that a benefit accrues to the recipient of a stock dividend. Such people show an utter disregard of the market quotations for stocks before and after stock dividends are declared. In most cases the old shares freely sell higher than the new shares, including the dividend. However, the feeling exists that some sort of a legal tax should be imposed and corporations are on notice that what could not be done directly may be done indirectly. In at least two states stock dividends have been held to be taxable income.[2]

Since imposition of the federal income tax in 1913, the author has consistently taken the position that the Supreme Court would decide that the declaration of a stock dividend could not be treated as a distribution of income. Those who are interested in the various laws, regulations, rulings and court decisions which preceded the handing down of the decision in the *Macomber* case in 1920 will find them discussed in detail in *Income Tax Procedure,* 1917 to 1920, both inclusive.

Procedure of current interest includes the definition of a stock dividend, the computation of gain or loss upon the sale of the old or new stock and the method employed in obtaining credit for or refund of the tax collected before the final decision.

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[1] *Eisner v. Macomber,* 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521, March 8, 1920. For full text of decision of court and minority opinion, see Corporation Trust Company 1920 Income Tax Service, pages 468-487.

[2] *State ex rel. Dulaney v. Nygaard,* 183 N. W. 884 (Wisc.); *Tax Commissioner v. Putnam,* 227 Mass. 522; 116 N. E. 904; L. R. A. 1917 F. 806.

What Is a Stock Dividend?

A stock dividend is a dividend declared by a corporation payable in stock of the same corporation. Uncertainty regarding stock dividends still exists.[3] Some confuse a stock dividend with a dividend payable in the stock of another corporation. Some hold that a dividend on common stock payable in preferred stock is not a true stock dividend.

The former view is clearly erroneous. The latter view has some merit; but the author is of the opinion that a dividend payable in any class of stock of the same corporation is not taxable.

The principal change in the 1921 law regarding stock dividends is the addition of the following:

> LAW. Section 201. . . . . (d) A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913. . . . .

The foregoing new section is reasonable. It would be unfortunate if a tax-exempt distribution, the equivalent of cash, could be made indirectly, whereas a direct distribution would be taxable. In providing that the proceeds of redemption of stock dividends shall be treated as dividends instead of as the proceeds of sales of stock, the law now recognizes the principle that the proceeds of the sale or redemption of stock dividends are free from the normal tax,[4] to the extent that the dividend represents a charge against surplus accrued since February 28, 1913.

The methods of issuing stock dividends have been described by the Treasury as follows:

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[3] See hearings before the Committee on Ways and Means, House of Representatives, March 18 and 19, 1920, page 38 *et seq.* The question as to whether a stock dividend can legally be declared in the state of Missouri has been decided in the affirmative. (C. B. 4, page 24; O. D. 887.)

[4] See page 770.

Definition of stock dividend.—

Ruling. . . . . 1. Where a corporation, being authorized so to do by the laws of the State in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders and the stockholders incur no liability for income tax by reason of its receipt.

Cash dividend with option or agreement to buy stock.—

2. Where a corporation, being thereunto lawfully authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new shares, such dividend is a cash dividend and is income to the stockholders whether they reinvest it in the new shares or not.

3. Where a corporation, which is not permitted under the laws of the State in which it is incorporated to issue a stock dividend, increases its capital stock and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder. (C. B. 3, page 38; T. D. 3052.)

The foregoing ruling is not sustained by the following:

Decision.[5] The sole question in this case is whether the dividend received by the defendant from the Gulf Oil Corporation in 1913, constituted taxable income within the meaning of the Act of Congress. If it be a stock dividend, then the plaintiff cannot recover, for the Supreme Court in Towne vs. Eisner, 245 U. S. 424, has held that a dividend received by the stockholder in shares of stock of the corporation, was not income within the meaning of the Act of 1913. It is clear that if the resolution declaring the dividend in question, had provided for the payment of the dividend in stock, the dividend would not have been taxable. It is also clear that the defendant received payment of the dividend in shares of stock, and that he did this pursuant to an agreement made prior to the declaration of the dividend, which agreement was communicated to the corporation before that declaration was made. It is clear that out of 112,680 shares, the holders of all but 1740 shares actually accepted payment of the dividend in stock, and that the money to pay cash to the holders of said 1,740

[5] *Lewellyn, Collector v. Mellon,* U. S. District Court, Western District of Pa. (July 13, 1921) (1913 Act).

shares was provided by T. Mellon & Sons pursuant to an agreement made before the declaration of the dividend, that they would take and pay for any such shares as the holders might refuse to accept as payment therefor. After the transaction, the defendant had two shares to represent the interest in the same property, which prior thereto was represented by one. After the transaction, there were twice as many shares of the corporation in the hands of stockholders as there were before. The corporate assets had not been diminished by the transaction. Therefore, for two shares which defendant possessed at the close, there was for him the same value as for one share represented at the beginning. . . . . In every view of the transaction, we find that its substance is clear. In cases like the present, substance is controlling, and not form. The courts look through all forms of corporate transactions, and have regard to the substance. *Southern Pacific Co. vs. Lowe*, 247 U. S. 330; *Gulf Oil Corporation vs. Lewellyn*, 248 U. S. 71 . . . . the Government urged upon the Court the necessity of observing the form, not in so many words but by their brief filed. They insist that the dividend was a cash dividend, because the resolution of the Board so stated. By implication, therefore, they would place the defendant in the position of having the right to use the check of the corporation, which as a matter of fact, never came into his hands, and which as a matter of fact, must have been drawn against "no funds," notwithstanding his agreement with his associates and with T. Mellon & Sons, and notwithstanding the important fact that without such agreements the resolution of the Board would never have been passed. That the Board would never have passed such resolution if there had been no such agreement, seems clear, not only from the testimony of the witnesses to that effect, but from other facts which appear in evidence, as, for instance, the absence of sufficient money and the limited credit possessed by the corporation, whose obligations to banks were given high standing by the endorsement of some of the very men who entered into the said agreement. In every aspect of this case, the defendant was not in the position where he was merely entitled to carry out his agreement, but he was bound to do so. The dividend in question seems to be a final step in a series of transactions having for their object the refinancing of the corporation, and was based upon earnings and accumulations by subsidiary companies through a period of years.

The foregoing decision, if maintained by the higher courts, would seem to make the following ruling illegal:

Stock dividends declared by national banks.—

RULING. In view of the fact that national banks are authorized by law to issue only cash dividends (see "Instructions of the Comp-

troller of the Currency Relative to the Organization and Powers of National Banks" for 1919, p. 50) such dividends, coupled with the right to apply same to the purchase of an increase in capital stock, are not within the decision of the Supreme Court in the *Eisner v. Macomber* case and are taxable income to the stockholder for surtax purposes. (C. B. 3, page 24; O. D. 588.)

When a national bank issues to its stockholders cheques which are supposed to be used in payment for new stock but are negotiable, so that a stockholder not wishing to purchase the new stock can freely divert the dividend to any other purpose, the dividend cannot be called a stock dividend. But if on each cheque were the words "stock dividend," and if most of the stockholders, pursuant to a general agreement, turned back the cheques in payment for new stock, it is probable that the courts will look through the form and find the substance to be a stock dividend. If the bank were to issue non-negotiable cheques, with conditions stated to the effect that the only possible use to be made of them would be to return them in exchange for shares of new stock without power of assignment or hypothecation, it may be assumed that the courts will hold this to be a stock dividend, on the ground that the national bank act did not intend that a bank should be deprived of privileges possessed by other corporations. On the other hand, a national bank receives from the government broad privileges, and an unusual supervision is maintained over its affairs, and it may not be feasible for a national bank to pay a dividend which would be held to be the equivalent of a stock dividend.

Stock dividend from surplus accumulated prior to March 1, 1913.—

RULING. . . . . 4. Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend

paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income. . . . . (C. B. 3, page 38; T. D. 3052.)

The Supreme Court has held that a stock dividend is not a distribution. Therefore, the cash dividend would be applied to the earnings accumulated after March 1, 1913. In other words, capitalizing surplus by means of a stock dividend will not serve to render cash dividends tax-free unless and until the surplus accumulated since March 1, 1913, has been distributed in cash.

Stock dividend in preferred stock.—A dividend in preferred stock is held not to be taxable,[a] because the amount thereof is transferred from surplus to capital, and as each existing stockholder receives a pro rata share of the new preferred stock there is no change whatever in the evidences of interest in the corporation's net worth. Each stockholder has the same proportionate share after the dividend as before. If the charter or by-laws of a corporation permitted it to distribute new stock to certain of its stockholders to the exclusion of others it could hardly be deemed to be a stock dividend.

If there is an existing issue of preferred stock and additional shares of preferred are issued to common stockholders as a dividend, the position of the common stockholders will be changed if the earnings are insufficient to pay the preferred stock dividend or in case of dissolution.

Ruling. A stock dividend paid in true preferred stock is exempt from tax the same as though the dividend were paid in common stock; however, if the stock issued and distributed as a dividend ranks with or prior to the interest of general creditors with respect to the payment of either interest or principal), it can not be considered true preferred stock, and must be treated as income to the recipient. (C. B. 4, page 24; O. D. 801.)

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[a] Art. 1548. See page 774.

Stock dividends received from subsidiary companies.—When a subsidiary corporation declares a stock dividend, the holding corporation owning the majority of the stock of such subsidiary, if it has not theretofore taken up the surplus of the subsidiary, may set up on its books as an asset its interest (the percentage of its ownership of stock) in the surplus capitalized on the books of the subsidiary corporation for the purpose of the stock dividend. This should be done, however, only in case the subsidiary has earned, since the acquisition of ownership by the holding corporation, profits of an amount which at least equals the amount of surplus so capitalized. In other words, if the holding company owned 93 per cent of the subsidiary, it would be justified in entering on its books the stock dividend at a value equal to 93 per cent of the amount of surplus transferred to the capital account on the books of the subsidiary. The amount so transferred or capitalized is ordinarily, if not invariably, the par value of the stock issued as a dividend.

It has been urged that the dividend may be set up "at the same value as the cost per share of its original holdings in said subsidiary," but this is not correct. Assuming that $100 per share, i.e., the par value, is regarded as the cost to the holding corporation, the statement quoted would produce the same result as the above rule. This, however, would really be a mere coincidence. If the holding corporation has purchased control for more or less than par, and if this value is so recorded on its books, such procedure would not produce the desired results.

The holding corporation could of course declare a stock dividend on the amount that it credits to surplus on account of the value placed on the stock dividend received from the subsidiary.

Dividend paid in stock of another corporation is not a stock dividend.—When a new corporation has been organized to take over certain properties of an old corporation and the

stock that the new corporation paid to the old for such properties is distributed as a dividend to the stockholders of the old corporation, the dividend is held to be taxable and not a stock dividend.[7]

RULING. . . . . 5. A dividend, paid in stock of another corporation held as a part of the assets of the corporation paying the dividend, is income to the stockholder at the time the same is made available for distribution to the full amount of the then market value of such stock (*Peabody v. Eisner*, 247 U. S. 347); and if such stock be subsequently sold by the stockholder, the difference between its market value at date of receipt and the price for which it is sold is additional income or loss to him, as the case may be. . . . (C. B. 3, page 38; T. D. 3052.)

This ruling is sound. If the stock received does not have a fair market value, the equivalent of cash, no tax can be imposed until sale is made.

The proceeds of sale, when realized, are free from the normal tax. Section 216 of the law would appear to free dividends from the normal tax in any event, but the intention of the section is to apply the credit for the normal tax only up to the earnings or profits upon which income tax has been imposed.[8]

Computation of Profit or Loss on Sales of Stock Dividends or of Stock upon Which Such Dividends Were Declared

Under the 1918 and prior laws, the Treasury treated the proceeds of sales of stocks and liquidation dividends as sales of property (stock) and failed to allow credit to stockholders for the normal tax which had been paid by corporations. If the Treasury's theory is correct, the carrying of a stock dividend for two years now enables the holder to take advantage of the 12½ per cent tax on capital gains. The loss of the

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[7] *U. S. v. Phellis*, Supreme Court No. 260, October Term 1921, advance opinions, 66 L. Ed. 69. Also see cases cited on page 739.

[8] Section 216 (a). See pages 347-350.

credit for normal tax is in every case of a substantial income far more than offset by freedom from surtax rates.

The author, however, does not believe that the past practice of the Treasury regarding dividends has been in accord with the laws.[9]

General rules for ascertaining cost.—

REGULATION. Stock issued by a corporation as a dividend does not constitute taxable income to a stockholder in such corporation, but gain may be derived or loss sustained by the stockholder from the sale of such stock. The amount of taxable gain derived or deductible loss sustained from the sale of such stock, or from the sale of the stock with respect to which it is issued, shall be determined as provided in article 1561, after the cost, or both the cost and fair market value as of March 1, 1913, if acquired prior thereto, of both the old and the new shares is determined in accordance with the following rules:

WHEN SHARES ARE OF SAME CHARACTER.—

(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share (or when acquired prior to March 1, 1913, the fair market value as of such date) will be the quotient of the cost (or such fair market value) of the old shares of stock, divided by the total number of the old and new shares. . . . . (Art. 1548. Reg. 45, Art. 1547.)

COMMENTS ON REGULATIONS.—Proceeds of the sale of stock dividends declared out of the earnings accumulated since March 1, 1913, should be entered as dividends received up to the par value of the stock, in order to receive the benefit of the credit for the normal tax. The excess, if any, above par value, less the cost as ascertained by using the formula in the regulation, constitutes a profit and is taxable as such.

If the profit is not sufficient to permit this method, one should enter the proceeds, up to the par value of the shares, as a dividend and claim credit as a realized loss for the difference between cost and the total price realized, less the amount entered as a dividend. This works out as follows:

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[9] See page 748.

Cost on July 1, 1913 (new corporation) of 100 shares		$10,000.00
Stock dividend, in 1921, 100 shares		
Total shares	200	
Total cost (average cost per share $50)		$10,000.00
In 1921 sell 100 shares for		$10,000.00
Cost of 100 shares		5,000.00
Taxable profit		$ 5,000.00

As the corporation charged the 1921 dividend to its surplus account and paid the normal income tax thereon as the earnings were realized during 1913 to 1921 and credited to surplus, the stockholder's holdings as to $50 per share on 200 shares or $100 per share on 100 shares are free from normal tax. Therefore the taxpayer would in this case enter the entire profit of $5,000 as a dividend received.

Again:

Cost on July 1, 1913, of 100 shares		$10,000.00
Stock dividend in 1921, 100 shares		
Total shares	200	
Total cost (average cost per share $50)		$10,000.00
In 1921 sold 200 shares for		$12,000.00
Cost of 200 shares		10.000.00
Taxable profit		$ 2,000.00

The corporation has paid the normal tax on $10,000. In order to secure the benefit thereof the taxpayer must enter in his 1921 return a dividend[10] of $10,000 and take credit for a loss of $8,000, thus accounting for realized net income of

[10] It is, of course, not a dividend in a technical sense, but the returns are not flexible enough to permit its entry in any other way. The transaction should be explained on the return.

$2,000, which will be subject to the surtax. If the taxpayer were merely to return the $2,000 as a profit the entire credit for the normal tax paid on $10,000 would be lost.

It is clear that the recipient of a stock dividend when being taxed on the proceeds thereof is entitled to the benefit of the normal tax which the corporation has already paid on the earnings since March 1, 1913. The new regulations conform to this principle.

This principle has been followed by the Treasury in denying to taxpayers the right to treat dividends on preferred stocks as entitled to credit for the normal tax when the paying corporations have not been taxed on the net income from which the dividends are derived.[11]

RULING. In explanation of rule 2 contained in article 1547 [Regulations 45][12] . . . ., the following example is given:

The X Company, which has outstanding a certain number of shares of common stock of a market value of $90 per share, declares a 10 per cent stock dividend payable in preferred stock having a market value of $120 per share. A, who owns 100 shares of common stock having a market value of $9,000, receives 10 shares of preferred stock which have a market value of $1,200, making the market value of his holdings on the date of the receipt of the dividend $10,200, of which 15/17 represents the value of the common stock and 2/17 the value of the preferred stock. If the common stock cost the shareholder $8,500 (or if it was acquired prior to March 1, 1913, and had on that date a value of $8,500) such cost or value shall be apportioned to the common and the preferred stock in the ratio of 15 to 2. In other words 15/17 of $8,500, or $7,500, represents for the purpose of determining gain or loss the "cost" or the fair market value, as the case may be, of the 100 shares of common stock in respect to which the preferred stock was issued. The basis for determining the gain or loss arising from the sale of any share of such common stock will, therefore, be $75.

Of the $8,500 representing the original cost of the 100 shares of common stock, or their market value as of March 1, 1913, if they were acquired prior to that date, 2/17, or $1,000, will represent the "cost" of the 10 shares of preferred stock received as a dividend, the basis for determining the gain or loss upon the sale of each share of such stock being $100. (C. B. 3, page 39; O. D. 732.)

[11] C. B. 1, page 93; O. D. 328.
[12] Art. 1548.

In tabulated form, this appears as follows:

	Market value per share	Total market value	
100 common	\$ 90 [13]	\$9,000	(a)
10 preferred	120	1,200	(b)
		\$10,200	(c)

Ratio of (a) to (c) = 15/17 × \$8,500 = \$7,500 = new cost of 100 common
Ratio of (b) to (c) = 2/17 × \$8,500 = \$1,000 = new cost of 10 preferred

WHEN SHARES ARE OF DIFFERENT CHARACTER.—

REGULATION. . . . . (2) Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid, the cost (and when acquired prior to March 1, 1913, the fair market value as of such date) of the old shares of stock shall be divided between such old stock and the new stock, in proportion, as nearly as may be, to the respective values of each class of stock, old and new, at the time the new shares of stock are issued, and the cost (or when acquired prior to March 1, 1913, the fair market value as of such date) of each share of stock will be the quotient of the cost (or such fair market value as of March 1, 1913) of the class to which such share belongs divided by the number of shares in that class. . . . . (Art. 1548. Reg. 45, Art. 1547.)

PURCHASES AT DIFFERENT TIMES AND DIFFERENT PRICES.—

REGULATION. . . . . (3) Where the stock with respect to which a stock dividend is issued was purchased at different times and at different prices and the identity of the lots can not be determined, any sale of the original stock will be charged to the earliest purchases of such stock. . . . . and any sale of dividend stock issued with respect to such stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the dividend chargeable to such stock.

(4) Where the stock with respect to which a stock dividend is declared was purchased at different times and at different prices, and the dividend stock issued with respect to such stock can not be identified as having been issued with respect to any particular lot of such stock, then any sale of such dividend stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the stock dividend chargeable to such stock. (Art. 1548.)

[13] The market value of \$90 is considered to be *after* the dividend is distributed.

The last paragraph (4), of the foregoing regulation was not in the old regulations.[14] When the dividend stock cannot be identified as issued to any particular purchase, it must now be allocated to the earliest purchased stock. Formerly, a taxpayer was permitted to "allocate, according to his wishes."[15]

The author has suggested in previous editions of this work that purchases should be averaged as such method accords with good accounting practice. It is easily computed and readily understood and in the long run produces the same amount of tax.

If the average method is not used, the principle of allocation to the earliest purchases has been stated in a recent case[16] as follows:

DECISION. . . . . The law may, and in fact does, recognize an identity in every share, which can indeed be traced upon the books of the company, at least until certificates are consolidated and later subdivided. The purchase of a number of shares can be earmarked by the certificate, and it is an enormous convenience to keep the purchase separate. Yet it is possible and consistent when new shares are declared to attribute them ratably in subdivision of those already issued. They are not so entered on the books, it is true, but the books are not kept in accordance with the underlying doctrine of *Eisner* v. *Macomber*, 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521, in any event. At least the earlier certificates need not lose their separate identity because new shares are filiated to them in proper proportion.

An illustration will make clear what I mean. Suppose a man has certificate A, for 100 shares, bought at $100, certificate B, for 100, bought at $150, and certificate C, for 100, bought at $200. Suppose, further, that a stock dividend of 50 per cent is declared, and he gets one certificate D, for 150 shares, without paying anything. If he sells certificate A, he would be deemed to sell not the whole of his first purchase, but only two-thirds of it, and he could credit himself with only $6,666. If he sold certificate B, he would credit himself with $10,000, and if certificate C with $13,333. If he sold certificate D, he could credit himself with $15,000, made up of $3,333 from his first purchase, $5,000 from his second, and $6,666 from his third. If, on the other hand, he sold only a part of certificate D, some arbitrary rule of apportionment must be adopted, allocating the

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[14] T. D. 3238 (October 22, 1921) added paragraph 4 to Art. 1547, Reg. 45.

[15] C. B. 3, page 40; O. D. 735.

[16] *Towne v. McElligott*, U. S. District Court, Southern District of New York, 274 Fed. 960 (August 5, 1921).

shares sold among his purchasers. The most natural analogy is with payment upon an open account, where the law has always allocated the earlier payments to the earlier debts, in the absence of a contrary intention. Accordingly, if all the new shares were not sold at once, I think the first sales would be attributed to the first purchases still remaining unsold when the stock dividend was declared. I do not see that this method will result in confusion in its application, and it carries into effect the underlying theory of *Eisner* v. *Macomber*, supra.

The two illustrations given below show the procedure to be followed.

			Cost	Market Value
Purchased	10	shares common @ $100	$1,000	$ 900(a)
"	40	" " @ 80	3,200	3,600(b)
"	30	" " @ 40	1,200	2,700(c)
Total	80		$5,400	$7,200

10% Stock Dividend:

	1	share preferred	$ 80(d)
	4	" "	320(e)
	3	" "	240(f)
Total	8		$640

Ratio of (a) to (a) + (d) = 900/980=91.8
Ratio of (b) to (b) + (e) = 360/392=91.8
Ratio of (c) to (c) + (f) = 270/294=91.8

Per cent	Total
91.8 × $1,000 = cost apportioned to first 10 shares of common = 91.80 per share	$ 918.00
91.8 × $3,200 = cost apportioned to second 40 shares of common = 73.44 per share	2,937.60
91.8 × $1,200 = cost apportioned to third 30 shares of common = 36.72 per share	1,101.60
Total original cost	$4,957.20

The above reveals that when sales are made from any one of the three lots shown a different cost is used for each lot.

In contrast with this method is the use of an average, to which the Treasury objects, viz.,

91.8 per cent of $5,400 (total cost as above) = $4,957.20 total new cost
Total cost apportioned to old shares divided by number of old shares = $4,957.20 ÷ 80 = 61.97 average cost of old share.

The following computation illustrates the allocation of the cost between stock originally purchased and dividend stock of

a different class when several different lots were purchased at different prices:

When more than one stock dividend is received, and various purchases have been made, the effect of the receipt of each stock dividend is to reduce the proportion of the cost to be assigned to each share of the increased number of shares. Each lot of purchased stock will usually carry a different original cost, and sales are made gradually eliminating the earliest purchases. There is thus a continually changing basis on which to compute profit from sale.

STATEMENT OF ACQUISITION OF STOCK AND COST

		No. of Shares	Cost
1909	Purchased	1,000	$ 84,800.00
1910	Stock dividend 33⅓%	333⅓	....
	Purchased	3⅓	495.75
	Total (average $63.81 per share)	1,336⅔	$ 85,295.75
1911	*Deduct:* Shares given to son, taken at $63.81 per share	16⅔	1,063.50
Mar. 1, 1913	Held at this date	1,320	$ 84,232.25
1914	Received as legacy, taken at market value at date of decedent's death	200	40,000.00
1917	(1) Stock dividend 50%	760	....
1918	Purchased	120	24,000.00
1919	(2) Stock dividend 25%	600	....
1920	(3) Stock dividend 40%	1,200	....
	Totals	4,200	$148,232.25

ALLOCATION OF STOCK DIVIDENDS TO EARLIEST PURCHASES OR ACQUISITIONS TO DETERMINE PROFIT ON SUBSEQUENT SALE

	No. of Shares	Cost
Stock held at March 1, 1913, at market value at that date	1,320	$264,000.00
(1) 50% stock dividend received in 1917 (50% of 1,320)	660	
(2) 25% stock dividend received in 1919 (25% of 1,980)	495	
(3) 40% stock dividend received in 1920 (40% of 2,475)	990	
	3,465 at $76.19 =	$264,000.00

Stock received as a legacy in 1914	200	$ 50,000.00
(1) 50% stock dividend received in 1917 (50% of 200)	100	
(2) 25% stock dividend received in 1919 (25% of 300)	75	
(3) 40% stock dividend received in 1920 (40% of 375)	150	
	525 at $95.24 =	$ 50,000.00
Stock purchased in 1918	120	$ 24,000.00
(2) 25% stock dividend received in 1919 (25% of 120)	30	
(3) 40% stock dividend received in 1920 (40% of 225)	60	
	210 at $114.29 =	$ 24,000.00
Total shares owned at June 30, 1921—as above	4,200 at $80.48 =	$338,000.00
1921 Stock sold at	1,000 at $70.00 =	70,000.00
Cost per share of shares owned at March 1, 1913, after allocating stock dividends = $84,232.25 ÷ 3,465 shares	$ 24.31	
Cost of 1,000 shares sold in 1921	$24,310.00	
Value as at March 1, 1913,[17] of 1,000 shares sold in 1921	$76,190.00	
Proceeds of 1,000 shares sold in 1921	$70,000.00	

Since the sales price is less than value at March 1, 1913, but more than cost, the taxpayer reports neither gain nor loss.

In the case of a sale of 1,000 shares received as stock dividend (par $100,000), the amount to be reported as dividend and also deducted on return so as to secure the benefit of the normal tax which has been paid by the corporation on the earnings transferred to capital account through issuance of stock dividends, is computed as follows:

March 1, 1913, shares owned	1,320
Dividend stock allocated to holdings at March 1, 1913	2,145
Total shares in lot to which sale in 1921 is allocated	3,465
Shares sold in 1921 (having par value of $100,000)	1,000

Portion of $100,000 representing proceeds of sale of stock dividends exempt from normal tax:

$$\frac{2,145}{3,465} \times \$100,000 = \ldots\ldots \$61,904.76$$

[17] See ruling (C. B. 1, page 31; A. R. 6).

In order to secure the benefit of the credit for normal tax, the entire $61,904.76, when part of sale is original holdings and part is stock dividend, and, when wholly the proceeds of sale of stock dividend, should be entered as a dividend on one side and as a loss on the other side of the return.

Dividends paid in scrip are stock dividends.—

RULING. A corporation declared a dividend payable in stock of the company at par. In making the distribution of fractions of shares scrip certificates were issued. In order to facilitate the disposal for the stockholders of their scrip, where they did not desire to purchase additional scrip to entitle them to a full share of new stock, the corporation sold in the open market as an agent of the stockholders the scrip certificates received for fractional shares of dividend stock. The sale was entirely optional with the stockholders.

Held, that the scrip certificates received as a dividend do not represent a cash dividend but a stock dividend and are not subject to tax. (C. B. 4, page 24; O. D. 859.)

Fractional shares must be used in ascertaining new cost.— When fractional shares of stock are received as a dividend, they serve to reduce the average cost. Sometimes adjustments are made in cash on account of such fractional shares, the cash payment representing the market price of the stock, which may be more than par. In such cases the amount of the payment should be returned as the proceeds of a dividend up to par and adjustment should be made for the excess, depending on cost of old stock or value at March 1, 1913.

RULING. The resolution of the board of directors of a corporation, declaring a stock dividend, provided that no fractional shares of stock should be issued, but that all fractions of shares should be united into whole shares and sold by the treasurer and the proceeds thereof paid to the stockholders entitled thereto, such resolution having been approved by the stockholders. Held, that the stockholders by approving the action of the board of directors approved and, in fact, authorized the action of the treasurer, in uniting and selling the fractional shares and paying over the proceeds therefrom to those stockholders entitled to the fractional shares, and that those stockholders entitled to receive fractional shares, but who actually received cash representing their portion of the proceeds of the sale

of the fractional shares should compute the gain or loss thereon under the provisions of Treasury Decision 3059.[18] (C. B. 4, page 28; O. D. 781.)

Stock dividends declared out of surplus created by a reappraisal of or appreciation in assets.—There may be some justification for reappraising physical assets, but there can be no good excuse for issuing stock for goodwill unless it has been made the subject of sale.

It is to be hoped that only few such instances occur. Any corporation which writes up the value of goodwill, credits the amount to surplus account, and out of such alleged surplus declares a dividend, may expect to be charged with practicing a fraud on its stockholders and on anyone who afterwards acquires the stock. Goodwill when it appears on the balance sheet of a corporation or partnership is supposed to be carried at cost price or less, and any action which tends to obscure this inference may result in deception, even if there is no intention to deceive.

Refund of Taxes Paid on Stock Dividends

Ruling. A claim for credit on Form 47A for payment of tax on stock dividends is to be accepted as a suspension of immediate collection of tax due only—

(1) Against income or income and excess-profits taxes due and unpaid.

(2) If amount claimed as a credit does not exceed the amount of tax collected on the stock dividend less any additional tax due and unpaid upon the sale of stock received as a dividend or stock upon which the dividend was declared. (The basis of determining the gain or loss upon sale of stock is stated in Regulations 45, article 1547, paragraphs 1 and 2. That article provides that the cost of each share of stock is the quotient of the cost of the old stock divided by the number of old and new shares added together.)

(3) When accompanied by an affidavit of the taxpayer (supported by statements from the corporation which distributed the dividends as to the amount distributed to the taxpayer and years

[18] C. B. 3, page 38: ". . . . that portion of the dividend paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax . . . . ."

in which the profits distributed were earned) covering the following information:

(*a*) Whether the dividend consists of stock of the corporation distributing the dividend to the taxpayer, or of stock of another corporation acquired by the distributor.

(*b*) The name of each corporation declaring, the declaration of, and the date of receipt by the taxpayer of, the stock dividends, the tax on which was paid and is covered by the claim.

(*c*) The year in which the stock dividend was included in the taxpayer's return of income.

(*d*) The number of shares the taxpayer received and the value placed upon the dividend in the return. (If no sale of stock was made, the taxpayer need not furnish the following information.)

(*e*) If any sale has been made of stock of the corporation declaring the dividends, whether the stock be that acquired by a dividend, or upon which the dividend was declared, state—

(1) The number of shares sold.

(2) The selling price.

(3) The date or dates of sale.

(4) The portion, if any, of the selling price included as taxable profit in the return of net income for the year the sale was made and the item in the return under which the amount was reported.

(*f*) State how many shares of stock the taxpayer owned at the time he received the first stock dividend; how much that stock cost the taxpayer and the date the stock was acquired. (If acquired prior to March 1, 1913, state its value on that date and manner of determining the value.)

(*g*) State separately the dates from March 1, 1913, upon which you received stock dividends, the number of shares received on each date, and the names of the corporations distributing the dividends.

The receipt or canceled check covering the payment of tax involved in the claim should be attached to the claim. (C. B. 2, page 246; M. 2436.)

Stock dividends on shares carried on margin with broker.—

RULING. A taxpayer in 1918 carried on margin with a stock brokerage firm shares of stock in a certain corporation. As the stock was not owned outright by the taxpayer it was not registered in his name but in the name of the broker, together with other shares carried under similar conditions. Subsequently the corporation paid a stock dividend to its recorded stockholders, of which the brokerage firm was one, and it in turn distributed the same proportionately to the marginal owners.

For the purpose of making claim for credit or refund of the

taxes paid on these stock dividends, the taxpayer should accompany his claim with a statement from the paying corporation showing the number of shares of stock standing in the name of the brokerage firm, and the amount of stock dividends paid to such firm during the year 1918; also a statement, signed by the brokerage firm, indicating the number of shares of the corporation's stock which the firm carried for his account, and the amount of stock dividends turned over to him by the brokerage firm. (C. B. 3, page 308; O. D. 625.)

Can recipient of stock dividend on which tax was paid refuse to accept refund of tax?—Taxpayers, who received stock dividends on which income tax has been assessed and collected and have since sold their stock, may have suffered a loss which they would not have incurred if Congress had not made such a mess of the whole subject of the taxation of stock dividends.

It might be possible for anyone who has sold his stock to maintain this position: that having followed the law and the regulations, and having paid the tax assessed against him, he was justified in assuming that the matter was entirely closed. In other words, the government would be estopped from collecting a greater tax in such cases.

If thereafter he sold the stock received as a dividend and reported the proceeds of sale in accordance with the law and the regulations, having paid the tax assessed upon him, he was again justified in assuming the matter was closed.

If he is compelled to accept a refund of the tax paid on account of the dividend and amend his return on account of the sale, he may be assessed for a very large additional tax for which he would not have been liable except for the action of Congress.[19]

Does Stock Dividend Belong to Life Tenant or to Remainderman?

On the question whether a stock dividend goes to the life tenant as income or to the remainderman as capital, there are at least three rules.[20] The United States Supreme Court[21] and

[19] For further comment and illustration, see *Income Tax Procedure*, 1920, pages 498-9.

a minority of state courts give it to the remainderman. Among the states is Massachusetts,[22] although it holds the dividend taxable as income. England gives the stock dividend to the life tenant if it is an ordinary dividend and to the remainderman if it is an extraordinary one.[23] New York,[24] Pennsylvania[25] and several other states[26] split it. What comes from corporate profits acquired subsequent to the creation of the trust goes to the life tenant. What comes from earlier accumulations is kept for the remainderman.

Retroactive Tax on Stock Dividends

Mr. Wayne Johnson, Solicitor of Internal Revenue, testifying before the Committee on Ways and Means of the House of Representatives said:

> It has been decided by the Supreme Court in the Brushaber[27] case that we could have an act retroactive in its features, and that has been done. . . . . An excise tax, or any other tax, on the issue of stock based on capitalization of surplus, which would be equivalent in amount to the revenues which we have lost on account of the adverse stock dividend decision, would be perfectly valid. . . . .

Since the foregoing statement was made the 1921 law has been enacted. It contains no provision for the imposition of an excise tax on stock dividends. It is therefore most unlikely that any further attempt will be made to impose a retroactive tax on stock dividends, to recoup the revenue lost by the government by reason of the Supreme Court decision.

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[20] "The Judicial Debate on the Taxability of Stock Dividends as Income," by Thomas Reed Powell, *Bulletin of the National Tax Association,* May, 1920, page 247.

[21] *Gibbons v. Mahon,* 136 U. S. 549, 34 L. Ed. 525, 10 S. Ct. 1057.

[22] *Minot v. Paine,* 99 Mass. 101.

[23] See note on pages 801-802 to *Brander v. Brander,* 4 Ves. Jr. 800 (Am. Ed.) ; 31 Eng. Rep. 414.

[24] Matter of Osborne, 209 N. Y. 450, 50 L. R. A. (N. S.) 510, Am. Ann. Cas. 1915 A. 298, 52 N. Y. Supp. 48; affirmed, 166 App. Div. 547.

[25] Earp's Appeal, 28 Pa. St. 368.

[26] See cases cited in *Tax Commissioner v. Putnam,* 227 Mass. 522, 532.

[27] *Brushaber v. Union Pac. Ry. Co.,* 240 U. S. 1, 36 S. Ct. 236, 60 L. Ed. 493.

CHAPTER XXIV

INCOME FROM PARTNERSHIPS, LIMITED PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

The 1921 law made no change in the status of the partnership under the income tax law.[1] Like the previous laws, the present one in effect ignores the partnership's existence as an independent entity and taxes the partners on the income from the business in substantially the same manner as though the income were received from an individual business enterprise.

What is a partnership under income tax law?—There are three classes of taxpayers upon which in all cases, or in specific cases, taxes are imposed upon what is known as a partnership basis. This simply means that the tax is not levied upon a group or an entity, but upon the individuals who compose the group. These groups are:

1. Common law partnerships
2. Limited partnerships of a certain type
3. Personal service corporations.[2]

Under the federal income tax laws the treatment of the foregoing classes is not entirely uniform. Individual members of common law partnerships are uniformly taxed as individuals. Members of limited partnerships may or may not be taxed as individuals. Stockholders of personal service corporations are supposed to be taxed as individuals, but the federal income tax law lacks the power to change a corporation into a partnership and the attempt to do so has resulted in certain complications which are discussed hereafter.

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[1] As in the case of the 1918 law, it relieves partnerships of the excess profits tax.

[2] Only to December 31, 1921; after that date personal service corporations are taxed as ordinary corporations.

General ownership.—Ordinarily when two or more persons are associated together for the purpose of conducting a business for profit, they are deemed to constitute a partnership. The following article points out when certain relationships do not constitute a partnership.

REGULATION. Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners. In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership. The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners. (Art. 1507.)[3]

A joint venture entered into by agreement between a United States corporation and an individual was held not to be a partnership.[4]

When the net losses, if any, were to be borne by one of the parties, it was held that this one fact was insufficient to show that the agreement was not a partnership.[5]

RULING. A taxpayer and several others were the subscribers to a syndicate agreement of which B was the manager, the purpose of which was the purchase of stock in a certain corporation. The articles state that "nothing herein contained or otherwise shall constitute the parties hereto partners," and there is no evidence that a partnership was in fact established. The agreement further provides that no subscriber shall be liable except to the extent of his individual obligation. The legal and equitable title to the stock was in the subscribers, a fact inconsistent with the view that the syndicate was either a corporation or association. Nothing in the agreement indicates a trust relationship.

. . . . The relation is called subscriber and manager and is analogous to client and broker. The broker buys and sells the stock, realiz-

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[3] **[Former Procedure]**

RULING. Article 1507, Regulations 45 (revised) applies to situations arising under both the Revenue Act of 1917 and the Revenue Act of 1918. (C. B. 2, page 11; O. D. 411.)

[4] C. B. 1, page 9; O. D. 96.

[5] C. B. 2, page 11; S. 1361.

ing a profit or loss reflected in the client's account. The entrance of others into this relation as joint principals does not affect it. The relationship remains that of principal and agent.

Held, that these agreements constituted the principals joint owners in a joint venture. As such each is taxable in his individual capacity on income from that source. Each subscriber has an interest in the joint account of such a nature that a pro rata profit or loss inures to him on each completed transaction evidenced by a purchase and sale of stock at a higher or lower price as the case may be.

Dividends upon the stock held by the syndicate should be reported in the taxpayer's return for the year in which the dividends were declared and collectible in the proportion which his interest bears to the total amount of stock held by the syndicate.

The average cost to the syndicate can not be set up as a basis for establishing a loss to the taxpayer upon the termination of the agreement when he paid to the syndicate the excess of the purchase price over the market price on that day.

The sale of his stock at the lower market price to a new syndicate at the termination of the first agreement would constitute a closed transaction reflecting a loss to the extent that such stock is not transferred to him as his pro rata share of the new syndicate. (I-2-15; I. T. 1156.)

The foregoing ruling states that the net income of subscribers is based upon closed transactions. These no doubt are subject to deductions for expenses. It would seem necessary for the managers to render periodical reports to subscribers in order that the latter may return the aggregate net income for the taxable periods.

Return of estimated profits on joint accounts.—

Ruling. In case two distinct partnerships enter into a single venture under agreement to terminate in two years no part of profit to be distributable or drawings allowed during that period and any profit to be held intact until the latter part of 1919, the amount of profit realized and determinable each taxable year should be reported proportionately in the respective returns of the partnerships regardless of the agreement. Individual members of each partnership are subject to tax upon their pro rata share of profit even though actual distribution is postponed until termination of the agreement. (C. B. 1, page 174; O. D. 187.)

The foregoing is sound only so far as there is an amount of "realized and determinable" profit before the end of the

period. If it is a single venture there can hardly be a realized profit unless and until the venture as a whole is closed. The case is not analogous to the closing of books upon an inventory or accrual basis.

Domestic partnerships.—The following regulation defines a domestic partnership:

REGULATION. A domestic . . . . partnership is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, and a foreign . . . . partnership is one organized or created outside the United States as so defined. . . . . The nationality or residence of members of a partnership does not affect its status. A partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership. . . . . (Art. 1509.)

The Treasury has also issued several rulings defining partnerships.[6]

RULING. A, and B, his wife, founded a hospital under an oral agreement that it was to be their joint business. The original investment of approximately *x* dollars was contributed by B. The building for the enterprise is owned jointly by A and B and the balance of the property used in the business is owned by them equally. The profits arising from the enterprise over and above living expenses have been placed back in the business and the losses, if any, are charged to the enterprise. The powers and responsibilities are equally divided, each party having authority to draw checks, receive payments, and perform similar acts. Neither party may dispose of his or her interest without the consent of the other.

Since there is an equal sharing of the profits and losses, a community of interest, a mutual agency between the parties to the agreement, and an intention to form a partnership, and since a wife may enter into a partnership with her husband in the particular State, the business conducted by A and B is held to be a partnership for the purpose of Federal taxation. (I-1-2; I. T. 1151.)

Annual Returns by Partnerships

Partnerships pay no income taxes as entities, but the partners are individually taxable on their distributive shares.

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[6] See B. 40-21-1850; A. R. R. 629; and B. 33-21-1772; Sol. Op. 117.

Nevertheless, every partnership must, under the 1921 law[7] file an annual return giving the data necessary for the determination of the distributive shares.

LAW. Section 224. **That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.**

The return should be made on form 1065. (See Appendix.) The Commissioner has extended the time for filing partnership returns for 1921 until May 15, 1922.[8] This extension does not apply to members of partnerships. It will be necessary for them to apply for an extension, unless a general extension is authorized.

REGULATION. The return of a partnership shall state specifically (*a*) the items of its gross income enumerated in section 213 of the statute; (*b*) the deductions enumerated in section 214, other than the deduction provided in paragraph (11) of subdivision (a) of that section; (*c*) the amounts specified in subdivisions (a) and (b) of section 216 received by the partnership; (*d*) the amount of any income, war profits and excess profits taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (*e*) the names and addresses of the individuals who would be entitled to share in the net income of the partnership if distributed; (*f*) the amount of the distributive share of such net income of each such individual; and (*g*) such other facts as are required by form 1065. (Art. 412.)

Consolidated returns.[9]—The 1918 law did not either permit or require partnerships to make consolidated returns with

[7] **[Former Procedure]** Before 1918 partnerships were required to file returns only upon special request of the Commissioner or collector. (Reg. 33, 1918, Art. 30.) Such requests were made in 1914, but none subsequently except that under the 1917 law returns were required from all partnerships as a basis for the assessment of excess profits tax. (Section 211.) The 1918 law required returns.

[8] T. D. 3272, dated January 19, 1922.

[9] This subject is also discussed further in Appendix A, Chapter XIV, "Consolidated Returns of Affiliated Corporations."

corporations the stock of which was owned by them. The 1921 law, while not specifically permitting taxpayers to include partnerships in consolidated returns, authorizes the Commissioner to consolidate the accounts of two or more related businesses of corporations or partnerships or individuals owned or controlled by the same interests.

LAW. Section 240. . . . . **(d) . . . . in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.**

REGULATION. . . . . This provision relates not to the *payment* of taxes, but to the determination of the true income of related trades or businesses and thus indirectly to the *amount* of taxes which may be due under Title II (income taxes) and Title III (excess profits taxes) of the statute. (Art. 637.)

It would appear only equitable that the Commissioner should exercise the power conferred on him by section 240 (d) in every case where a consolidation of partnership accounts with other partnership or corporate accounts is necessary to obviate hardship which would otherwise be imposed on a partnership. Therefore, taxpayers should request the Commissioner to exercise his power in those cases where it seems necessary to the imposition of only a fair tax on profits of partnerships having affiliations with corporations or other partnerships.[10]

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[10] **[Former Procedure]** No provision whatever for consolidated returns, either of corporations or partnerships, appeared in either the 1913 or 1916 laws. In the administration of the 1917 law, the Treasury permitted consolidated returns by corporations for excess profits purposes but not for income tax purposes. The 1921 law confirms this administrative procedure as follows:

LAW. Section 1331. "(a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

Distributive shares of partners—taxability.—

REGULATIONS. Partnerships as such are not subject to taxation under the statute, but are required to make returns of income. . . . . Individuals carrying on business in partnership are, however, taxable upon their distributive shares of the net income of such partnership, whether distributed or not, and are required to include such distributive shares in their returns. The net income of the partnership shall be computed in the same manner and on the same basis as the net income of an individual, except that the deduction of contributions or gifts is not permitted, as these are allowable deductions to the respective partners in their individual returns. (Art. 331.)

The distributive share of the net income of the partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either (*a*) for the taxable year upon the basis of which the partner's net income is computed, or (*b*), if the partner's net income is computed upon the basis of a taxable year different from that upon the basis of which the net income of the partnership is computed, for the taxable year of the partnership ending within the taxable year upon the basis of which the partner's net income is computed. Amounts earned and distributed to a partner by a partnership after the end of its taxable year and before the end of his corresponding taxable year should be accounted for both by the partnership and by the partners in their returns for their next succeeding taxable years. Where the result of partnership operation is a net loss, the loss will be divisible by the partners in the same proportion as net income would have been

"(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

"(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917."

divisible, unless the partnership agreement provides for the division of a loss in a manner different from the division of a gain, and may be used by the individual partners in their returns of income. (Art. 332.)

ESTABLISHMENT OF FISCAL YEARS.—Section 226 of the 1921 law makes it possible for a partnership to change from a calendar year to a fiscal year, a fiscal year to a calendar year or one fiscal year to another.[11] The procedure is fully outlined in the chapters on returns.[12]

Partnership fiscal years.—

LAW. Section 205. . . . . **(c) If a fiscal year of a partnership begins in 1920 and ends in 1921, or begins in 1921 and ends in 1922, then (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of such partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.**

The 1921 law with net income differently computed and different rates of tax in 1922 than under the 1918 law, involves adjustments in case of fiscal year partnerships so as to tax the income in accordance with the law in effect when the income was earned.

FISCAL YEARS 1920-1921.—The following regulation prescribes the method for ascertaining the amount of partnership income attributable to the portions of the calendar years 1920 and 1921 included within the partnership fiscal year.

REGULATION. If the fiscal year of a partnership began in the calendar year 1920 and ended in the calendar year 1921, the method of computing the taxes of the partners is as follows: (*a*) The amount

[11] **[Former Procedure]** In the past it was customary to require a partnership to give notice of the establishment of a fiscal year thirty days prior to March 1. (Reg. 33, 1918, Art. 31.)

[12] See page 69 *et seq.*

of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1920 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1920 (Title II of the Revenue Act of 1918) and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the taxable period falling within the calendar year 1920 bears to the entire taxable period; (*b*) the amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1921 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1921 and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the taxable period falling within the calendar year 1921 bears to the full taxable period. (Art. 334.)

Although the rates of tax for the years 1920 and 1921 imposed upon the income of the individual members of partnerships are the same, there are certain differences in the computation of net income under the 1918 and 1921 laws, which will affect the tax applicable to the portions of the years 1920 and 1921, included in the partnership fiscal year. The chief differences are:

1. Allowance for net losses.
2. Additions to reserve for bad debts.
3. Interest paid to carry certain Liberty bonds.
4. Dividends from certain foreign corporations and from appreciation at March 1, 1913.
5. Exempt Liberty bond interest.
6. Loss on "wash sales."
7. Credits for foreign taxes.
8. Income from business carried on in a possession of the United States.

The foregoing regulation prescribes three steps:

(1) Determine the net income for the full fiscal year:

(a) Under the 1918 law (for 1920).

(b) Under the 1921 law.

(2) Compute each partner's share as if for a full year, viz.,

(a) His share of (1-a).
(b) His share of (1-b).

(3) Each partner's share is deemed to be the sum of:
(a) That portion of (2-a) which the part of the fiscal year falling in 1920 is of a full year.
(b) That portion of (2-b) which the part of the fiscal year falling in 1921 is of a full year.

The amount of net income in (3-a) is taxable at rates in effect for year 1920 (under the 1918 law); the net income in (3-b) is taxable at the 1921 rates (under the 1921 law).

FISCAL YEARS 1921-1922.—

REGULATION. If the fiscal year of the partnership began in the calendar year 1921 and ends in the calendar year 1922 the rates of tax for the calendar year 1921 apply to the amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1921, and the rates for the calendar year 1922 to the amount of each partner's distributive share of such income of the partnership attributable to the calendar year 1922. (*a*) The amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1921 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1921 and the distributive share thereof of each partner, and then taking such proportion of the distributive share as the part of the taxable period falling within the calendar year 1921 bears to the entire taxable period; (*b*) the amount of each partner's distributive share of the net income of the partnership for such fiscal year attributable to the calendar year 1922 is found by determining the net income of the partnership for its entire fiscal year in accordance with the law applicable to the calendar year 1922 and the distributive share thereof of each partner, and then taking such proportion of that distributive share as the part of the taxable period falling within the calendar year 1922 bears to the entire taxable period. . . . . . (Art. 335.)

The principles governing the computation of net income attributable to the calendar years 1921 and 1922 are the same as illustrated herein above for fiscal years 1920-1921. While a fiscal year ending in 1922, however, is affected by only one law, viz., the 1921 law, the capital gains provisions thereof are

not effective until January 1, 1922.[13] The restriction on losses from "wash sales" is not effective until November 23, 1921. The different treatment of such items under the same law, but as applied differently in the years 1921 and 1922, requires that two computations of net income be made, each for the full fiscal year:

1. As if the fiscal year was the calendar year 1921.
2. As if the fiscal year was the calendar year 1922.

From this point the procedure for determining the pro rata part attributable to 1921 and 1922 is the same as illustrated above for 1920-1921 fiscal years.

EXAMPLE

Assume the following: A partnership with fiscal year ended September 30, 1921, has net income for the full year of $40,000 (when computed under the 1918 law). When computed under the 1921 law, the net income for the full fiscal year is $36,000. Partner A has a one-half interest in the profits.

A's income from the partnership would be computed as follows:

I

Net income for full year under 1918 law as above.......	$40,000	
A's share (½ of $40,000)...........................	$20,000	
Taxable at 1918 rates (3 months falling in 1920, or ¼ year), ¼ of $20,000		$ 5,000

II

Net income for full year, under 1921 law as above......	$36,000	
A's share (½ of $36,000)...........................	$18,000	
Taxable at 1921 rates (9 months falling in 1921, or ¾ year), ¾ of $18,000		13,500
Total to be reported		$18,500

Application of different rates for fiscal years 1921-1922.[14]—

REGULATION. . . . . In determining the rates of tax applicable to the amounts of the distributive shares of the partners attributable

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[13] See page 627.

[14] **[Former Procedure]**

Application of rates of previous years.—

1918 LAW. Section 206. "That whenever parts of a taxpayer's income

to the calendar years 1921 and 1922, respectively, the amounts subject to the rates for the calendar year 1922 shall be placed in the lower brackets of the rates schedule provided in the present statute, and the amounts attributable to the calendar year 1921 in the next higher brackets of the rates schedule applicable to that year. (Art. 335.)

Congress did not re-enact in the 1921 law the provisions of section 206 of the 1918 law which provided for the superimposition of income of the earlier year on that of the later year. The Treasury in the foregoing regulation follows the method previously prescribed by the 1918 law. The 1921 law is not specific as to how the computation should be made.

An illustration will make clear the application of the method.

EXAMPLE

Assume that A has income from a partnership (a one-fourth interest therein) with fiscal year ended June 30, 1922, and that there are no items requiring different treatment in 1921 and 1922.

Partnership profits, 12 months ended June 30, 1922	$100,000
A's share (¼ of $100,000)	$ 25,000
Other income in calendar year 1922	1,000
Total income to be reported	$ 26,000
Taxable at 1922 rates:	
½ of A's share of partnership income	$ 12,500
Other income	1,000
Total	$ 13,500
Taxable at 1921 rates:	
½ of A's share of partnership income	$ 12,500

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are subject to rates for different calendar years, the part subject to the rates for the most recent calendar year shall be placed in the lower brackets of the rate schedule provided in this title, the part subject to the rates for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to that year, and so on until the entire net income has been accounted for. In determining the income, any deductions, exemptions or credits of a kind not plainly and properly chargeable against the income taxable at rates for a preceding year shall first be applied against the income subject to rates for the most recent calendar year; but any balance thereof shall be applied against the income subject to the rates of the next preceding year or years until fully allowed."

REGULATION. Section 206 of the statute applied to a partner's share of partnership net income, to a stockholder's share of the net income of a personal service corporation. . . . . (Reg. 45, 1641.)

The tax is computed as follows:

Net income	$13,500	
Less: Exemption	2,000	
	$11,500	
Taxable at 4%	4,000	$160
Taxable at 8%	$ 7,500	600
Surtax at 1922 rates on $13,500		125
Total tax at 1922 rates		$ 885

Normal tax, $12,500 at 8%	$1,000	
The surtax commences with the next highest bracket, viz.:		
$13,500 to $14,000: $ 500 at 5%	25	
14,000 to 16,000: 2,000 at 6%	120	
16,000 to 18,000: 2,000 at 7%	140	
18,000 to 20,000: 2,000 at 8%	160	
20,000 to 22,000: 2,000 at 9%	180	
22,000 to 24,000: 2,000 at 10%	200	
24,000 to 26,000: 2,000 at 11%	220	
Tax on 1921 income		$ 2,045
Total tax for calendar year 1922 (payable by individual)		$ 2,930

The tax on the remaining $12,500 of income taxable at 1921 rates is assessed normal tax at the full 8 per cent rate, the specific exemption of $2,000 having already been used, and the first $4,000 taxable at 4 per cent having also been used already in the computation above, at 1922 rates.

Partnerships for 1921 may be taxed as corporations.—In order to avoid the high surtaxes imposed upon individuals, the 1921 law extends to partnerships the right retroactively to incorporate their business for the year 1921. It is provided that capital must be an income-producing factor, in which case incorporation may take place at any time up to March 23, 1922.

LAW. Section 229. That in the case of the organization as a corporation within four months after the passage of this Act of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits

or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided*, That this section shall not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year: *Provided further*, That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.

In no case would it be beneficial for a partnership to incorporate retroactively for 1921 unless the earnings were large and had not been withdrawn from the business.

Changes in partnership during taxable year.—There are many changes in partnership relations which do not involve dissolution of an existing partnership. When changes occur during a fiscal year, because of the death or withdrawal of a partner or the admission of a new partner, and when the partnership continues except as to the changes mentioned, no good purpose would seem to be served by making returns until the end of the taxable year.

REGULATION. . . . . Whenever a new partner is admitted to a partnership, or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain or loss has been realized by any partner. . . . . (Art. 1570.)

The reference to the "next return" would not indicate that an immediate or special return was required. In any event every partnership return is merely an "information" return and is useful only after the returns on which it is a check are filed.

Return by receiver of partnership.—Article 424 of Regulations 62 provides that "a receiver in charge of the business of

a partnership shall make a return for it on form 1065." This also would be in the form of a return of information and would not be a return on which the tax would be directly assessed. It would, however, indicate the distributive profits or losses of the partners during the period covered by the receivership. When a receiver is appointed for a partnership the same person is usually made receiver for each of the partners.

Net Income of Partners—How Determined

The general provision of the law governing the taxation of partnerships, which includes all partnerships, except limited partnerships of the "corporation" type, reads as follows:

LAW. Section 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed. . . . .

The regulations, except for article 332,[15] do not attempt to elaborate this section of the law.

The return of the partnership (form 1065) serves two useful purposes: (1) It is such a compilation as would have to be prepared by the partnership in any event, in order to assemble and segregate the taxable, partly taxable and non-taxable income and the allowable and non-allowable deductions. (2) After the compilation is made the distributive share of each partner is so stated as to set forth clearly the manner in which it should be taken up in the partner's individual return.

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[15] See page 790.

Net income of a partnership defined.—The tax is to be levied on the distributive shares "of the net income of the partnership," and this phrase is defined in the law as follows:

LAW. Section 218. . . . . (c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed. . . . .

Section 212 describes the method of determining the net income of individuals and section 214 (a-11) permits the deduction of certain gifts[16] up to 15 per cent of the taxpayer's net income. The effect of the section of the law quoted above, therefore, is to put a partnership on exactly the same basis as an individual, so far as determining net income is concerned, with the single exception that gifts of the type described may not be deducted. The distributive shares of the partnership profits, however, form a part of the individual partner's "net income," from which such gifts may be deducted up to the limit of 15 per cent. Consequently no disadvantage accrues to the partnership because of the provision forbidding the deduction.[17]

Whether or not the contributions made directly by the partnership exceed the 15 per cent limit, the individual partners must return as their share of the net income of the partnership the full distributive share without any deductions for contributions. The credit to which each partner is entitled depends upon the entire taxable income of the partner and is

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[16] See Chapter XXXIV.

[17] **[Former Procedure]**

RULING. Recommended, upon reconsideration of the appeal of the M Company, a partnership, that the action of the Income Tax Unit in disallowing a deduction on account of contributions made to the American Red Cross in 1917 by the partnership be reversed, and that the firm be allowed, under the provisions of section 206 of the Revenue Act of 1917, to deduct charitable contributions or gifts, as described and limited in section 5 (a) of the Revenue Act of 1916, as amended, even though such contributions were not so closely connected with the trade or business as to secure to it some definite benefit or consideration.

Committee Recommendation 245 (C. B. 3, page 323), is hereby revoked. [B. Digest 45-21-1914; A. R. 651 (Sol. Op. 116).]

The foregoing ruling is in accord with the author's position as stated in *Income Tax Procedure*, 1919, page 830.

not affected by the relation of the contributions of the firm to the total income of the firm.

Donations should be charged to a special ledger account. The donation account should be closed by transfers to the partner's accounts. Each partner would be able to determine whether or not the 15 per cent allowance had been exceeded in his case. This special account should include only those donations subject to the 15 per cent limitation. All other donations, properly classified as expenses, should be charged to appropriate expense accounts.

CREDITS FOR CERTAIN DIVIDENDS AND INTEREST, NORMAL TAX ONLY.—The "distributive share" upon which the partner is taxable includes certain items which when received directly as a part of an individual's income are subject only to the surtax rates. Such items are dividends from certain classes of corporations, and interest on certain government securities whose terms of issue provide for exemption from the normal tax. The law definitely provides that the identity of these items shall be preserved so that each partner may claim as a credit his proportionate share of the income represented by them.

LAW. Section 218. . . . . **(b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership. . . . .**

Subdivisions (a) and (b) of section 216 describe the dividends and interest referred to.[18]

REGULATION. In addition to the credits ordinarily allowed to an individual, a partner is entitled to the following credits: (*a*) A credit against net income for the purpose of the normal tax only of proportionate shares of such dividends specified in section 216 (a) and article 301, and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the partnership; and (*b*) a credit against income tax of the partner's proportionate share of any income, war

[18] See pages 681 and 704.

profits, and excess profits taxes of the partnership paid or accrued during the taxable year to a foreign country or to any possession of the United States subject to the limitations of section 222 of the statute. (Art. 333.)

The procedure regarding exemption for dividends, interest and taxes[19] is fully outlined in the respective chapters dealing with those subjects and in the chapters on returns.

INTEREST ON TAX-EXEMPT BONDS TO BE ENTIRELY OMITTED FROM THE CALCULATION OF NET INCOME.—The basis prescribed for the calculation of net income in section 218 (c), quoted on page 799, plainly excludes entirely interest upon tax-exempt securities.[20]

IDENTITY OF INCOME OF PARTNERSHIP—HOW FAR TRACEABLE.—In the gross earnings or expenses of a partnership there may be items other than the specified dividends or interest which would be favorably treated in the returns of individuals if segregated from the partnership profits. If there are such items partners may confidently report them separately unless and until partnerships are taxed as entities.[21]

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[19] **[Former Procedure]** CREDIT FOR 1917 EXCESS PROFITS TAX RESTRICTED TO 1917 INCOME.

LAW. Section 218. "(c) In the case of an individual member of a partnership which makes return for a fiscal year beginning in 1917 and ending in 1918, his proportionate share of any excess-profits tax imposed upon the partnership under the Revenue Act of 1917 with respect to that part of such fiscal year falling in 1917, shall, for the purpose of determining the tax imposed by this title, be credited against that portion of the net income embraced in his personal return for the taxable year 1918 to which the rates for 1917 apply."

This provision is equitable. The partner's tax on 1917 profits, not reported until 1918, should be based on 1917 rates; therefore the credit for the 1917 excess profits tax was applicable against the 1917 income, not against 1918 income.

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[20] **[Former Procedure]** For full discussion of the foregoing, see *Income Tax Procedure,* 1919, pages 372-373.

[21] **[Former Procedure]** Regulations 33 were subject to criticism. It happens that under the 1916 law, the 1918 law and the new 1921 law the kinds of partnership income which it is an advantage to "identify" are "specially provided for." Therefore taxpayers are not concerned at present about the restriction. For text of old regulations, court decisions and comments, see *Income Tax Procedure,* 1920, page 505.

RULING. An individual member of a partnership received a salary for services performed as an employee of a city and, in accordance with his contract with the firm, turned over to it, as the value of his time, the entire amount so received.

Held, that the individual partner might deduct the amount of the salary in his personal return as a business expense, but that no deduction could be claimed by the partnership, since to allow the amount received by it to be treated as exempt income would in effect be to regard it as an employee of the city, which was not the fact. (C. B. 2, page 104; A. R. M. 25.)

The foregoing ruling does not so state, but it must be assumed that the partner rendering the service omits the salary from his return even though he deducts the entire amount turned over to the firm.

INFORMATION NEEDED TO TAKE ADVANTAGE OF CREDITS AND DEDUCTIONS.—In view of the credits and deductions set forth in the preceding paragraphs, the partner should, before preparing his personal return, secure from the partnership specific information regarding the following points in addition to the mere statement of net profit or net loss.[22]

1. Dividends received:
   - (a) When from domestic corporation not entitled to benefits of section 262.[23]
   - (b) When from foreign corporation which derives 50 per cent of its gross income from sources within the United States.[24]
2. Interest received upon "obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income under section 213" of the law.[25]

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[22] Which it is assumed would be drawn up in accordance with the law and the regulations. See page 788.

[23] See pages 347 to 350.

[24] See page 711.

[25] **[Former Procedure]** The 1918 law required that interest entirely exempt, including that received on Farm Loan bonds, be reported but not included in net income. The 1921 law did not re-enact this requirement. See page 801.

3. Gifts.[26]
4. Foreign income or excess profits taxes.[27]
5. Capital gains and losses (see Chapter XVII).

DEDUCTION FOR PARTNERSHIP LOSSES.—Partnership losses are, of course, deductible in the returns of the individual partners. The following regulation explains the basis of division among partners:

REGULATION. Losses sustained during the taxable year . . . . are fully deductible . . . . if (*a*) incurred in the taxpayer's trade or business, ... (Art. 141.)

Even though the distributive share on the firm's books is a net profit, if the aggregate of dividends and interest described on page 799 is greater than the net profit the difference is an allowable deduction as a loss to the partner.

If the books of a partnership show a net profit of $40,000 with two equal partners, each is subject to *surtax* on his distributive share, irrespective of the character of the income. If the firm received $50,000 in dividends each partner should return $25,000 from that source and claim credit for a loss of $5,000. The amounts entered as dividends will be free of normal tax, and the difference between $25,000 and $5,000 ($20,000 each) will automatically be subject to the surtax, which commences at $5,000[28] for 1921, and at $6,000 for 1922.

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[26] See Chapter XXXIV.

[Former Procedure] When fiscal years ended in 1918, other than at December 31, 1918, it was necessary to know the amount of partnership income subject to the 1917 income and excess profits tax rates.

[27] For method of obtaining credit, see Chapter XXVIII.

[28] [Former Procedure].

RULING. . . . . . In the case of a partnership sustaining operating losses the question arises as to whether or not the full distributive share of dividends received by the partnership should be included in the amount reported on line 25, page 2, of the form for 1913, eliminating any entry on line 19. The effect of this, if nothing further is done, would be to return the entire distributive share of the dividends received by the partnership as liable to surtax, no notice being taken of the operating losses.

The Committee is of the opinion that the correct method of treatment is to include on line 25 the total distributive share of dividends and to enter on line 32 a proportionate share of the losses sustained, which would have the effect of including, for surtax purposes only, the net distributive share of the partnership income. (C. B. 2, page 168; A. R. M. 13.)

Net loss provision applies to partnerships.—

Law. Section 204. . . . . **(b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.**

(c) The benefit of this section shall be allowed to the members of a partnership. . . . .

Regulation. . . . . Where the result of partnership operation is a net loss, the loss will be divisible by the partners in the same proportion as net income would have been divisible, unless the partnership agreement provides for the division of a loss in a manner different from the division of a gain, and may be used by the individual partners in their returns of income. (Art. 332.)

This subject is discussed in detail in Chapter XXIX.

Profits from sale or exchange of capital assets.—Since the 1921 law taxes capital gains on a different basis from other profits,[29] it is necessary for partnerships to keep a separate record of all sales or exchanges of capital assets.

Law. Section 206. . . . . **(c) In the case of a partnership . . . . the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership . . . . . and shall be taxed to the member . . . . as provided in sections 218 . . . . , but at the rates and in the manner provided in subdivision (b) of this section.**[30]

Regulation. Under subdivision (c) of section 206 the members of a partnership shall be taxed as provided in section 218, but with respect to any capital net gain, may elect to be taxed as provided in section 206. Similarly estates or trusts or the beneficiaries thereof shall be taxed as provided in section 219, but with respect to any capital net gain may elect to be taxed as provided in section 206. In all cases, however, of election to be taxed under section 206 the minimum tax on the total net income (ordinary net income plus capital

[29] This subject is discussed in detail in Chapter XVII. See page 627.
[30] See page 628.

net gain) is 12½ per cent. Where the net income of a partnership, estate, or trust consists in whole or in part of capital net gain, there shall be attached to the return, upon the request of any member or beneficiary (or without such request) at the election of a fiduciary of an estate, a statement showing (1) all items of capital gain, capital loss, and capital deductions, as provided in article 1652, and (2) the names of members or beneficiaries and the amounts of their respective shares in such capital net gain. (Art. 1653.)

The members of partnerships may elect the basis upon which they will be taxed. This may result in the same capital gain being taxed on two different bases as to the respective shares of partners therein.

The accounting period.—The partner is taxable[31] on his distributive share of the net income "for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed." The 1918 law, it will be recalled, permitted an individual, for the first time, to report on the basis of his fiscal year. The phrase just quoted makes it clear that a partnership having a fiscal or closing period different from that of the individual partner, need not attempt to make an additional closing of the books or ascertainment of profits or losses in order that the partner may return his share of the net profits or losses of the partnership for his full, personal fiscal year. Different partners may, indeed, have fiscal years ending at various dates and to insist upon a closing of the books in each instance would be out of the question.

What the government wants from an individual who is a partner in one or more firms is a full and accurate return of his share of the partnership profits for the twelve months ending at some date during his personal fiscal year. The acceptance of this as sufficient obviates the necessity of guessing or roughly calculating the partner's income when the fiscal year of the partnership does not agree with that of the partner. It is convenient and accurate to report the amount shown by

[31] Section 218 (a).

the partnership records, and, as the income tax has come to stay, individuals should change their own fiscal periods to the regular closing date of their partnerships.

It should be borne in mind that so-called salaries paid to partners are in effect a distribution of anticipated profits (Chapter XXVI). They may, however, have been deducted on the partnership books in determining the net annual profits distributable at the end of the fiscal year. *If so deducted* such salaries should be included as taxable income, for the year in which received, in each partner's individual return, in addition to his remaining share of the partnership profits for the fiscal year mentioned above.

When a partnership begins business at some date other than January 1 and it is intended to establish a fiscal year ending twelve months thereafter the partnership would make no return as of December 31. If the partners keep their personal books on the same fiscal year basis no return would be required for December 31. But if the partners do not establish fiscal years they must report as of December 31. In their returns for the first calendar year, neither profit nor loss from the partnership would be returned.

Procedure when personal and partnership accounts are on different bases.—A partner may have been accustomed to keep his personal accounts on a cash basis, while his firm's accounts are on an accrual basis. In such a case he may continue to keep his personal accounts as before if it is not practicable for him to change to an accrual basis, but in reporting his share of firm profits or losses he must include the entire amount of profit or loss accrued to or incurred by him on the firm's books for the fiscal or calendar year. It is immaterial how or when he receives his share, and whether or not the firm's books include many accrued items.

Dissolution of or changes in partnership.—

REGULATION. When a partner retires from a partnership, or it is dissolved, he realizes a gain or loss measured by the difference be-

tween the price received for his interest and the cost to him of his interest in the partnership, including in such cost the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost as hereinbefore provided and the value of such interest as of such date, plus the amount of the share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, shall be ascertained and the taxable gain derived or the deductible loss sustained shall be computed as provided in article 1561. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. Whenever a new partner is admitted to a partnership, or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain or loss has been realized by any partner. (Art. 1570.)

Upon the dissolution of or a change in a partnership and a distribution of assets in kind it is not probable that any taxable gain or profit would immediately arise. In a distribution upon the basis of book values there is no gain or loss, because it will be assumed that the partners in their individual returns will have accounted for all gains, profits or income which were shown on the books of partnership. When the accounts of the partnership in dissolution are continued a partner may await the result of the transactions for the entire taxable year before taking up in his accounts any gain or loss.

The foregoing regulation refers to the cases where a partner *realizes* in cash or its equivalent some amount greater or less than is shown in his capital account in the firm's books. The books may show that the book value of a partner's one-half interest in the firm is $50,000. Goodwill is not carried as an asset.

If the goodwill is valued at $40,000 and sold to the continuing partner or someone else for that amount the retiring partner will receive in cash $70,000. If the goodwill of the business on March 1, 1913, was worth $40,000 the retiring

partner will not realize any taxable gain. If the fair market value of the goodwill on March 1, 1913, was $25,000 the retiring partner must report a realized profit of $7,500. If the business was started after March 1, 1913, his taxable profit is $20,000.

Readjustment of partnership interests.—

Ruling. (1) . . . . If a retiring partner or the estate of a deceased partner takes his portion of the partnership property in kind there is no realization of income, such realization being postponed until the property so received is in turn sold.

(2) If, on the other hand, the retiring partner or the estate sells to the remaining partners his interest in the partnership for cash it is held that the difference between the cost, or value as of March 1, 1913, of such interest constitutes gain or loss for the purpose of computing the income of such partner or estate, and that the remaining partners, as a result of this transaction, have only added to their holdings in the partnership property. They have made a purchase and not a sale, and can have realized nothing in the way of profit or loss.[32] . . . . (C. B. 3, page 61; Sol. Op. 42.)

Assume that a retiring partner's capital account shows a credit balance of $25,000. He sells to a continuing partner for $20,000. If the latter subsequently converts the assets into the equivalent of cash at the book figures he will realize a profit of $5,000.

If, however, he purchases fixed assets or fails to convert other assets, the $5,000 credit to the retiring partner's account operates as a reserve and is not true surplus nor gain.

Ruling. . . . . (3) The effect of the admission of a new partner depends upon the terms of his admission. If, under the terms of the partnership agreement he contributes property or cash to the capital of the partnership he acquires a right, upon dissolution, to a return of his contribution together with his proportionate share of the net profits of the partnership business, and in the meantime to a corresponding share in the net earnings of the partnership. There is no realization on the part of any partner. If, on the other hand, he purchases, for cash, an interest in the existing partnership, it is clear that what he has acquired is simply a right to share in the profits of the partnership during its continuance and in any sum

[32] See Bulletin 37-21-1820; O. D. 1033.

remaining, upon the dissolution of the partnership, after the satisfaction of creditors and of the equities as between the contributing partners. Since this would represent a purchase, by the incoming partner, there could be no realization as to him, and, as to the members of the former partnership, the amount paid by him will clearly be income to them in direct proportion to their respective interests in the former partnership and should be returned by them as such. (C. B. 3, page 61; Sol. Op. 42.)

Assets of old partnership taken over at current valuation.—In the detailed opinion (see digest above), the specific question was stated as follows:

An opinion is requested whether upon the dissolution of a partnership by the withdrawal or death of a partner and the formation of a new partnership which takes over the assets of the old partnership belonging to the remaining partners, at current valuation, the transaction is to be considered closed so that the increase in the value of the assets as written up on the books of the new partnership over the cost or value as of March 1, 1913, of such assets to the former partners constitutes taxable income to them. . . . .

And the answer given by the Treasury confirms the position taken by the author that unrealized appreciation is not income.[33]

. . . . In other words, to hold that by valuing his contribution to the partnership at a greater amount than its cost to him, or value as of March 1, 1913, he could realize the difference as income would be to hold that the partner could make a profit by selling to himself. Such a conclusion is wholly at variance with the decisions of the courts and the rulings of this department. . . . .

Distributions to partners other than in cash.—A partner should return for taxation the exact amount credited to his capital account in the books of the firm at the end of its fiscal year, after deducting tax-exempt interest, etc. Any payments to a partner charged against his capital account are, of course, not returnable because such payments merely represent distributions of capital or of income already reported and taxed.

The same principle applies to partnership distributions

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[33] *Income Tax Procedure*, 1920, page 510.

other than in cash. For instance, a firm may own property or securities which it wishes to divide among the partners. The amount at which such items appear on the firm's books as assets determines the *book value* of the partners' interests therein, and when distribution is made the items should be entered by the partnership and the partners at book valuation. After distribution of the assets such book valuation is the basis of gain or loss, except that assets acquired before March 1, 1913, must be valued as of that date.

Ruling. Where a distribution of partnership profits is made in securities carried in an investment account by the partnership, first each partner must be taxed on the basis of his distributable share of the partnership profits for the year 1917, which partnership profits will be ascertained without claiming any loss with regard to the unsold securities held in the investment account of the partnership; second, the individual partners receiving these securities as a distribution of partnership profits shall determine their future gain or loss when such securities are sold and on the basis of the cost of the securities to the partnership or their market value on March 1, 1913, if acquired before that date. (C. B. 1, page 46; T. B. R. 34.)

Partnerships Composed of Corporations

As a general rule, a corporation cannot enter into a partnership.[34] In a few states, as in Texas, this rule has been changed by statute. The reason for the rule is that to allow a corporation to enter into partnership would be contrary to the general theory of the incorporation acts.[35] For income tax purposes, however, it has been held that a partnership composed of corporations should be classed as a partnership rather than as a corporation.[36] In regard to the case under consideration, it should be noted that the laws of Hawaii permit corporations to become members of a partnership. The subject is not of general interest enough to warrant a full discussion in these pages, but it may be said that unless the

[34] *Pearce v. Madison, etc., R. R. Co.,* 62 U. S. 441. See also Bulletin 42-21-1866; A. R. M. 139.

[35] C. B. 3, page 18; Sol. Op. 36.

[36] *Haiku Sugar Co. et al. v. Johnstone,* 249 Fed. 103.

charter of a corporation expressly prohibits its entering into partnership relations with other corporations or with individuals, it may do so, subject to the further possible restriction that the corporation laws of the state may inhibit such relationship.

Limited Partnerships

The Treasury draws a distinction between different types of limited partnerships, regarding one type as corporations and the other type as partnerships for income tax purposes.[37]

Limited partnerships may or may not be partnerships.—

REGULATION. So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan and Illinois limited partnerships are partnerships. A California special partnership is a partnership. (Art. 1505.)

LIMITED PARTNERSHIP AS CORPORATION.—

REGULATION. On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as distributions on the stock of corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partner-

[37] [Former Procedure] All limited partnerships were formerly considered corporations. (Reg. 33, 1918, Art. 62.)

ship association is a corporation. Such a corporation may or may not be a personal service corporation. (Art. 1506.)

OHIO PARTNERSHIPS.—

RULING. A partnership association or limited partnership organized under sections 8059-8078 of the Ohio Code is an association and not a partnership, within the meaning of section 1 of the Revenue Act of 1918, and is taxable as a corporation. (C. B. 2, page 11; O. D. 444.)

VIRGINIA PARTNERSHIPS.—

RULING. Virginia partnership associations or limited partnerships formed under sections 2878 to 2886, inclusive, of the Virginia code of 1904, are to be treated as corporations or joint-stock companies for income tax purposes.

The status of Virginia limited partnerships formed under the act of March 14, 1918 (acts of Assembly of Virginia, 1918), must be determined in each case by consideration of the certificate of partnership and all pertinent facts. (C. B. 1, page 9; O. D. 334.)

"PENNSYLVANIA" TYPE OF LIMITED PARTNERSHIPS.—Limited partnerships of the Pennsylvania type mentioned above are such as are organized under the act of June 2, 1874.[38] The limited or special partnerships, created by the acts of March 21, 1836,[39] April 6, 1870,[40] and June 15, 1871,[41] are not covered. The matter is discussed in an opinion from the Attorney General's department.[42] In general, so far as article 1506 applies to limited partnerships created under the act of June 2, 1874, it seems to be sound. Such a limited partnership is a quasi-corporation,[43] having many of the characteristics of a corporation. The limited partnerships of 1836, 1870 and 1871 are quite different and are not within the ruling in *Coal Company v. Rogers*, nor should they be within article 1506.

In the circumstances it would be better to designate limited partnerships, which must be treated throughout as cor-

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[38] P. L. 271.
[39] P. L. 143.
[40] P. L. 56.
[41] P. L. 389.
[42] 5 Pennsylvania District Reports 288.
[43] *Oak Ridge Coal Co. v. Rogers*, 108 Pa. St. 147.

porations, as being of the "corporation type" rather than the "Pennsylvania type."

RULING. The M Company, a partnership organized under the laws of the State of Pennsylvania, desires to be classed for Federal tax purposes as a limited partnership of the type mentioned in article 1506 of Regulations 45.

The said partnership differs from the type of partnerships provided for in the Pennsylvania statute in that the word "limited" does not appear in the firm name, yearly meetings of the partners are not provided for except by inference, no mention is made of a common seal and no provision is made for limiting the liability of the members. It differs from an ordinary partnership in that it is not dissolved by the death of one or more of the partners, but resembles a partnership and differs from a joint stock association or corporation in that it does not provide for the free transferability of the interest of a member.

It is held, therefore, that the M Company is a partnership and should be required to file returns as such. (C. B. 3, page 15; O. D. 599.)

Distributions by limited partnerships.—All divisions of profits by limited partnerships which are of the corporation type should be treated by the partners as dividends. The normal tax will have been paid, so that for 1921 the recipients will receive credit of 8 per cent on such distributions in calculating their normal tax.

Undivided profits will not be included in the returns of partners of the limited partnership as in the case with ordinary partnerships, but limited partnerships of the corporation type are subject to the excess profits tax.[44]

Personal Service Corporations Grouped with Partnerships

In an attempt to put partnerships and corporations on a more equal footing the 1918 law established a class of "personal service corporations" which are to be considered partnerships for income tax purposes. This provision was re-en-

[44] Discontinued after December 31, 1921.

acted by the 1921 law only for the year 1921. Personal service corporations are specifically exempt from the corporation income and excess profits tax.[45]

LAW. Section 218. . . . . (d) **Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof:** *Provided,* **That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares. . . . .**

Alternative tax on personal service corporations.—The stock dividend decision[46] of the Supreme Court, in which it is held in effect that stockholders cannot be taxed unless they actually receive income in their individual capacity as distinguished from income realized by the corporation as a separate entity, raised a grave doubt as to whether Congress had the right to tax stockholders of personal service corporations on the undistributed income of such corporations. Beginning with 1922, personal service corporations make returns and are taxed as other corporations.

To make certain, however, that personal service corporations or the stockholders thereof should not escape taxation entirely for the years 1918, 1919, 1920 and 1921 in the event that the personal service sections of the 1918 and 1921 laws are declared invalid, provision is made in the 1921 law for an alternative tax for the years mentioned, as regular corporations. In such event returns would have to be made for the years 1918, 1919, 1920 and 1921 as a regular corporation.

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[45] Law, section 231 (14). See page 46.

[46] *Eisner v. Macomber,* 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521. This was fully discussed by the Solicitor at the "Hearings before the Committee on Ways and Means, House of Representatives," March 18 and 19, 1920. See *Income Tax Procedure,* 1921, pages 643-645

LAW. Section 1332. (a) That if either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is by final adjudication declared invalid, there shall, in addition to all other taxes, be levied, collected, and paid on the net income (as defined in section 232) received during the calendar years 1918, 1919, 1920, and 1921, by every personal service corporation (as defined in section 200) included within the provisions of such subdivisions, a tax equal to the taxes imposed by Title II and III of the Revenue Act of 1918 and, in the case of income received during the calendar year 1921, by Titles II and III of this Act.

(b) In such event every such personal service corporation shall, on or before the fifteenth day of the sixth month following the date of entry of decree upon such final adjudication, make a return of any income received during each of the calendar years 1918, 1919, 1920, and 1921 in the manner prescribed by the Revenue Act of 1918 (or in the manner prescribed by this Act, in the case of income received during the calendar year 1921). Such return shall be made and the net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in the manner provided for other corporations under the Revenue Act of 1918 and this Act.

(c) If either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is so declared invalid, claims for credit or refund of taxes paid under both such sections shall be allowed, if made within the time provided in subdivision (f) of this section.

(d) In case the claims for credit or refund, filed within six months from such date of entry of decree, represent less than 30 per centum of the outstanding stock or shares in the corporation, the amount of taxes imposed by this section upon such corporation shall be reduced to that proportion thereof which the number of stock or shares owned by the shareholders or members making such claims bears to the total number of stock or shares outstanding.

(e) The tax imposed by this section shall be assessed, collected, and paid upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the taxes imposed by sections 230 and 301 of the Revenue Act of 1918 (or by sections 230 and 301 of this Act, in the case of income received during the calendar year 1921), but no interest or penalties shall be due or payable thereon for any period prior to the date upon which the return is by this section required to be made and the first installment paid. The amount of tax paid by any shareholder or member of a personal service corporation pursuant to the provisions of subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act shall be credited against the tax due from such corporation under this section upon the joint written application of such corporation and

such shareholder or member or his representatives, heirs, or assigns, if such application is filed with the Commissioner within six months from such date of entry of decree.

(f) Notwithstanding any other provision of law, no claim for a credit or refund of taxes paid under subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act, may be filed after the expiration of six months from such date of entry of decree: *Provided, however,* That a personal service corporation of which no shareholder or member has filed such claim within such period of six months, shall not be subject to the tax imposed by this section.

REGULATION. Section 1332 of the statute is an alternative measure and is of no effect unless and until either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of the statute of 1921 is declared invalid by final adjudication. (Art. 1736.)

There is a very serious doubt as to the constitutionality of the foregoing section of the law. While the Supreme Court has held consistently that retroactive tax laws are not unconstitutional, the author is of the opinion that the courts will find great difficulty in upholding this extension of retroactive legislation.

Many taxpayers accepted in good faith the provision of the 1918 law. Business has been conducted on this basis for over four years. There have been many sales of stock. And in many cases the profits have been distributed before the sales were made. In several outstanding cases taxpayers who controlled personal service corporations have died and control has passed to new owners.

The provision is probably illegal because it is an attempt to levy a tax by alternative legislation.

It will be recalled that the first draft of the 1918 excess profits tax law proposed alternative methods, but it was rejected because the "constitutional" lawyers in Congress said that it would be unconstitutional. Section 1332 is preceded by a heading which reads: "Alternative tax on personal service corporations." This heading was placed there by Congress. Therefore, there is no doubt about this being alternative legislation.

The courts have held with reference to curative statutes that if the defect is in the nature of the act itself, it cannot be obviated by a subsequent act.[47]

The following case, however, illustrates the injustice of this section:

During 1918, 1919, 1920, A owned all of the stock of a corporation which earned the following profits:

1918	$200,000
1919	250,000
1920	300,000

A dies in the early part of 1921 and his estate on account of the personal nature of the business decides to sell the stock of the corporation. Prior to A's death he had withdrawn and paid taxes on all of the profits each year because the business did not need capital.

With the death of A, the corporation lost its chief income-producing factor. The estate of A sold the stock for $50,000 to B, C and D, who had been faithful employees for many years. These employees had been in frequent contact with A's clients, and believed that they could continue the business.

Assume that in 1922 the courts hold that it was an error to have taxed A as a stockholder and instead the corporation should have been taxed.

The shocking result is that the faithful employees, B, C and D, are deprived of the earnings of the corporation. The corporation would probably be liable for the following taxes: 1918, $100,000; 1919, $80,000; 1920, $100,000; total, $280,000.

A legally withdrew all of the profits up to 1921. The estate therefore might collect a large refund on account of receiving credit for the normal tax now to be paid by the corporation.

B, C and D have no ground for an action against the estate. Exit B, C and D!

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[47] Cooley, Constitutional Limitations 382 (7th edition), page 544.

Returns of Personal Service Corporations

Generally speaking, all of the provisions of the 1921 law relating to returns apply alike to all classes of taxpayers.

Both the stockholders and the corporations have to make returns. The return of a personal service corporation is, however, as in the case of a partnership, merely an information return.

The Commissioner has extended the time for filing personal service corporation returns for the year 1921 until May 15, 1922.[48] This extension does not apply to the members of personal service corporations. It will be necessary for them to apply for individual extensions unless a general extension is made.

Regulations. Every personal service corporation must make a return of income regardless of the amount of its net income. It shall be made for the taxable year of the personal service corporation; that is, for its annual accounting period (fiscal year or calendar year, as the case may be), regardless of the taxable year of its stockholders. For the calendar year 1921 the return shall be made on Form 1065. If the personal service corporation makes any change in its accounting period, it will render the return in accordance with the provisions of section 226 of the statute and article 431. The return of a personal service corporation covering any period beginning prior to January 1, 1922, should state specifically (*a*) the items of its gross income enumerated in section 213 of the statute; (*b*) the deductions enumerated in section 214 of the statute, other than the deduction provided in paragraph (11) of subdivision (a) of that section; (*c*) the amounts specified in subdivisions (a) and (b) of section 216 of the statute received by the personal service corporation; (*d*) the amount of any income, war profits, and excess profits taxes of the personal service corporation paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (*e*) the amounts distributed by the corporation during its taxable year, with the dates of distribution and the names of the distributees; (*f*) the names and addresses of the stockholders of the corporation and their respective shares in such corporation at the close of its taxable year, and on December 31, 1921; (*g*) such facts as tend to show whether or not the corporation is a personal service corporation with reference to any period beginning prior to January 1, 1922; and (*h*) such other

[48] T. D. 3272, dated January 19, 1922.

facts as are required by the form. Earnings attributable to the calendar year 1922 and subsequent years are taxed to the personal service corporation in the same manner as the earnings of ordinary corporations are taxed. . . . . (Art. 624.)

. . . . An individual stockholder of a personal service corporation is subject to tax much like a member of a partnership upon his distributive share of the net income of the corporation earned on or after January 1, 1918, and prior to January 1, 1922. The net income of a personal service corporation attributable to the period prior to January 1, 1922, as in the case of a partnership, shall be computed in the same manner and on the same basis as the net income of an individual, except that the deduction of contributions or gifts is not permitted. . . . . (Art. 336.)

A stockholder of a personal service corporation is required to include in his gross income for each taxable year up to and including that taxable year within which falls the end of the last taxable period of the personal service corporation prior to January 1, 1922: (*a*) Any dividends paid by the corporation in such year out of earnings or profits accumulated since February 28, 1913, and before January 1, 1918; (*b*) his share of any distribution made by the corporation in such year out of earnings or profits accumulated since the close of its taxable year ending with or during his next preceding taxable year; and (*c*) his distributive share of the undistributed net income of the corporation for its taxable year ending with or during his taxable year provided he was at the close of its taxable year a stockholder in the corporation, notwithstanding he might since have ceased to be a stockholder. . . . . (Art. 338.)

Former stockholders of personal service corporations to whom distributive shares were assigned in the returns of the corporations, who reported such shares in their individual returns, should be careful when disposing of their stock to keep this fact in mind. Ordinarily when shares of stock are acquired the purchaser or donee is on notice that only the normal tax has been paid on the corporation's earned surplus account. In the case of a personal service corporation the surtax also will have been paid by or imposed on someone else from January 1, 1918, to the end of the taxable year next preceding the transfer of the stock (but not beyond December 31, 1921).

Personal service corporations with fiscal years ending in 1922.—One of the many evils of constant tinkering with

tax laws is the necessary adjustments which follow changes in rates. This problem confronts taxpayers in dealing with personal service corporations which have fiscal years beginning in 1921 and ending in 1922. Prior to the change in the 1921 law, the procedure for reporting in the stockholders' return income from a personal service corporation was complicated. Not only the gross distributive shares of accrued income had to be reported but dividends declared, and the period in which the earnings were accumulated were factors to be noted and reported.

LAW. Section 218. . . . . **(d) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof:** *Provided,* **That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares. . . . .**

Fiscal years of personal service corporations.—Beginning January 1, 1922, personal service corporations are taxed as ordinary corporations. In order to take care of the transition period—the change of basis from personal service corporation to regular corporation—the following provision was inserted in the 1921 law:

LAW. Section 218. . . . . **(d) . . . . In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated after December 31, 1920, shall be taxed to the distributees; and the stockholders of record on December 31, 1921, shall be taxed upon their distributive shares of the difference (if any) between such distributive profits and the portion of the corporation's net income assignable to the calendar year 1921, determined in the manner provided in clause (1) of subdivision (c) of section 205 of this Act.**

Fiscal years 1920-1921.—The treatment of partnership income illustrated in the preceding pages,[49] in the case of fiscal years ended in 1921, is applicable to personal service corporations with fiscal years 1920-1921.

Regulation. In the case of a personal service corporation having a fiscal year beginning in 1920 and ending in 1921, the corporation must make a return of income on Form 1065. The income for such year is not taxable to the corporation, but is taxable to the shareholders in a manner similar to that in which the earnings of partnerships are taxed. . . . . (Art. 337.)

Fiscal years 1921-1922.—Two returns must be filed for fiscal years ending in 1922.

Regulation. . . . . . In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, the return must be filed both on Form 1065 and on Form 1120. The net income attributable to the calendar year 1921 is that portion of the net income reflected upon Form 1065 (computed as if the fiscal year were the calendar year 1921), which the part of the taxable period falling within the calendar year 1921 bears to the entire period; and this amount is taxable to the shareholders of the corporation at the rates in effect as of December 31, 1921. The income attributable to the calendar year 1922 is that portion of the net income reflectd upon Form 1120 (computed as if the fiscal year were the calendar year 1922), which the part of the taxable period falling within the calendar year 1922 is of the entire period; and this amount is taxable to the corporation as the income of ordinary corporations is taxed. (Art. 337.)

The statement in the foregoing regulation "at the rates in effect as of December 31, 1921," is apt to be confusing. It does *not* mean that the personal service stockholder must take up in his 1921 return his share of earnings of the corporation undistributed at December 31, 1921. He takes this up in his 1922 return.

Example

Assume a personal service corporation with fiscal year ending March 31, 1922:

(1) Net income for full fiscal year computed under the law as

[49] See page 791.

applicable to the calendar year 1921 (to be reported on form 1065)	$40,000
(2) Net income for full fiscal year computed under the law as applicable to the calendar year 1922 (to be reported on form 1120)	$36,000*
(3) Net income attributable to 1921 (3/4 of $40,000)	$30,000
(4) Net income attributable to 1922 (1/4 of $36,000)	$ 9,000

* Difference in net income under the 1921 law (as between 1921 and 1922) may arise from "wash sales" (see page 591) capital gains (see page 627), etc.

Assume further that the net income of the personal service corporation for the fiscal year ended March 31, 1921, was $50,000. If the entire stock was owned by A, a single individual (reporting on the calendar year basis), and no dividends had been paid, in his 1921 return he would report $50,000, representing his "share of the undistributed net income of the corporation for its taxable year ending with or during his taxable year."[50]

If the corporation on December 15, 1921, had paid a dividend of $20,000, A would have to report same in his 1921 return in addition to the $50,000 referred to above.

Income to be reported by stockholder of personal service corporation.—

Regulation. . . . . In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated during its current taxable year are taxable to the distributees and should be reported in the personal returns of such distributees, and the stockholders of record on December 31, 1921, of such personal service corporation must report as income their distributive shares of the difference (if any) between such distributive profits and the portion of the corporation's net income assignable to the calendar year 1921, determined in the manner provided in section 205 (c) (1) of the statute and articles 334, 335, and 337.

The earnings of the personal service corporation attributable to the period subsequent to December 31, 1921, are taxable to the stockholder only when distributed, as in the case of dividends of ordinary corporations. (Art. 338.)

The words "distributive profits" in the last clause, second paragraph, of subdivision (d), section 218, quoted on page 820, read, in the House bill, "distributed profits." When the House bill was amended by the Senate, the above quoted clause

[50] Art. 338.

was carried over verbatim, except that the words "distributed profits" were changed to "distributive profits." (This apparently is a misprint and was not intended to be changed.) If we read the words as "distributed profits" the meaning will be made clear.

EXAMPLE

In the illustration given above assume that A is the sole stockholder at December 31, 1921. Then he must report in his 1922 calendar year return his "distributive share" of:

The portion of the corporation's net income assignable to the calendar year 1921	$30,000
Less: Profits distributed (dividend paid December 15, 1921)	20,000
Taxable at 1921 rates	$10,000

The $10,000 taxable at 1921 rates represents A's "distributive share of the difference . . . . between such *distributed* profits and the portion of the corporation's net income assignable to the calendar year 1921," referred to in article 338 quoted above.

Prerequisites of a Personal Service Corporation

The language defining a personal service corporation is very clear. The 1921 law re-enacted the definition of the 1918 law without any change.

LAW. Section 200. . . . . **(5) The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.**

The following illustrations used by Mr. Kitchin when the 1918 law was under consideration, may be regarded as an authoritative expression of the intention of Congress.[51]

[51] *Congressional Record*, September 18, 1918, page 11329, but this was said before the provision was inserted eliminating "traders" from the scope of the definition.

An insurance agency that writes insurance on commissions and requires no capital; a corporation of architects, which requires no capital; a lawyers' guaranty title company that looks up titles and requires no capital; any company where the earnings may be ascribed primarily to personal services and in which capital is not a material income-producing factor. . . . . where it (capital) is not actually required—where the business does not require them to have capital.

The intention of the lawmakers is indicated also by subsequent statements. The following explanation was made on March 18, 1920, by Mr. Kitchin:[52]

The section provides that a personal service corporation is a corporation whose income is to be ascribed primarily to the activities of the principal stockholders or owners who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital invested or borrowed is not a material income-producing factor. It seems that there is nothing in the statute preventing an accumulation of surplus or profits. It may have a thousand stockholders, but 4 men may own, say, 75 or 60 per cent of the stock, and if those 4 men, say, the president, the secretary, the manager, and supervisor, or whatever they may be, give their active service to it, and you can attribute the profits they may make, or substantially all of their profits, to their services, then it is a personal service corporation under that section. If from the accumulated profits or surplus any substantial part of its income was derived, perhaps this of itself would take it out of the personal service corporation class.

The regulations and rulings of the Treasury have deviated more and more from legislative intent. It was to be expected from these expressions that the controlling test would be found in an answer to the question: "Is capital (invested or borrowed) a material income-producing factor?" No rule can be laid down which can be used as an infallible answer to the question. Each taxpayer who believes that he may claim the benefit of the section is entitled to have his claim considered on its merits.

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[52] Hearings before the Committee on Ways and Means, House of Representatives, March 18 and 19, 1920, page 38.

REGULATION. The term "personal service corporation" means a corporation, not expressly excluded, the income of which is derived from a profession or business (*a*) which consists principally of rendering personal service, (*b*) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (*c*) in which the employment of capital is not necessary or is only incidental. No definite and conclusive tests can be prescribed by which it can be finally determined in advance of an examination of the corporation's return whether or not it is a personal service corporation. In the following articles are laid down the general principles under which such determination will be made. (Art. 1523.)

This article denotes a direct departure from the law. The law states that capital must not be a "material income-producing factor." In (c) we find that capital of any kind must be unnecessary or only incidental. Under the law capital, so long as it is *not* material, may be employed. In each example cited by Mr. Kitchin some capital would be necessary.

It seems entirely to have escaped the attention of the Treasury that the *intention* of the law is clear enough. Many protests were made under the 1917 law regarding the hardships suffered by owners of closely held corporations wherein the capital was out of proportion to the business done or income earned. So-called small corporations were afforded relief under section 302. But this was not considered fair to those corporations in which capital is not material and compensation for personal services is a substantial factor. Section 218 (e)[53] is not and was not intended to be used as an exclusive remedy. It was expressly intended to be an inclusive remedy. It should be administered liberally. If the rulings hereinafter discussed are illustrative of all others which have been rendered it may be expected that the courts will be asked to grant relief in many cases.

Reduction in tax when part personal service corporation.—When any substantial part of the income of a corporation is from fees or personal services of any kind, it is the intention of the law to afford relief.

[53] 1918 law. The corresponding section of the 1921 law is 218 (d).

If it can qualify as a personal service corporation no excess profits tax is payable. If it cannot so qualify and capital is out of proportion to the net income or other unusual conditions exist, relief can be secured under sections 327 and 328.[54]

If at least 30 per cent of the total net income is from personal services and the remainder of the net income is from non-personal service activities, the part of the net income which is from personal services will be taxed at a less rate than if the entire income were taxed at the graduated excess profits tax rates.[55]

When "trading" corporations cannot qualify.—When 50 per cent of the *gross* income of a corporation consists of "gains, profits or income derived from trading as a principal" such corporation cannot qualify as a personal service corporation.[56]

Many close corporations carry on extensive business with little invested capital of their own. In some cases the funds necessary to carry on the business are derived from borrowed money and in other cases the trading is done as broker or agent. The reference in the law is to buying and selling on one's own account, which usually means taking title to goods and reselling them. It has no reference to certain types of brokerage and commission houses which do not take title to the property they sell and do not have a substantial amount of invested capital. In general, trading is any kind of commercial activity wherein buying and selling of commodities are concerned. Selling the product of one's brains or skill, or selling one's services would appear not to be "trading" in the strict sense of the section. Selling anything else would seem to be trading.

Ruling. Section 200 of the Revenue Act of 1918 excludes from personal service classification a corporation 50 per cent or more of

[54] See *Excess Profits Tax Procedure*, 1921.

[55] Section 303, 1918 law, which was re-enacted without change in the 1921 law. For illustration and comment, see *Excess Profits Tax Procedure*, 1921.

[56] Section 200.

whose gross income consists of gains, profits, or income derived from trading as a principal. It does not necessarily follow, however, that if 50 per cent or more of the gross income was derived from the personal service phase of the business, that the corporation may claim personal service classification. (C. B. 1, page 14; O. D. 1.)

There is no provision of the law which prohibits such a claim being made. If the company can meet the other tests, it is entitled to be classified as a personal service corporation.

"Trading" corporations may qualify.—Great care was taken in writing section 200. If there had been the slightest thought in the minds of the framers of the law that in no case should trading corporations be permitted to qualify as personal service corporations it would have been extremely easy to bar them. If it had been intended to exclude all corporations in which *some* trading is carried on, the provision covering trading would have read something like this: "but does not include . . . . any corporation, 10 per centum or more of whose gross income consists either (1) of gains, profits or income derived from tradings as a principal. . . . ." But we find that after giving long consideration to the subject the restriction as to trading gains, profits or income is 50 per cent or more. In other words, practically one-half of the income *may* be from trading and the corporation still may qualify. The words "trading as a principal" extend and do not limit the privileges. It is a fair inference from these words that all trading *not* as a principal is prima facie evidence of qualification as a personal service corporation.

Trading as a principal means buying and selling commodities on one's own account.

Corporation with substantial capital may qualify.—A detailed description of the kind of corporation that may qualify in the personal service class is given in the following:

RULING. The business of the M corporation is insurance brokerage and average adjusting, principally in connection with marine insurance. It was formed by a consolidation of several firms engaged

in the same line of business. None of these firms contributed any capital or any tangible assets except some office furniture. Both preferred and common stock were issued in comparatively large amounts. The preferred stock was issued to the directors at par in order to secure funds for payment of expenses and advances to directors in anticipation of earnings. The common stock was issued to the members of the constituent firms for an arbitrary amount merely as a basis for the apportionment of future earnings. It represented no tangible property and bore no relation to any estimated value of good will. No common stock could be held by anyone not an officer, director, or employee of the company.

All the directors are actively engaged in the business of the corporation. No substantial amount of capital is employed to lend to customers, or to buy or carry goods for the corporation or to buy insurance for its clients; nor are the accounts of its clients or customers financed or carried to any substantial extent. Ninety-five per cent of the gross income is derived from personal services rendered by the owners or principal stockholders of the corporation.

Held, that this corporation is a personal-service corporation within the meaning of section 200 of the Revenue Act of 1918, and that its excess-profits tax for 1917 should be computed at the 8 per cent rate imposed by section 209 of the Revenue Act of 1917. . . . . (C. B. 2, page 17; A. R. R. 46.)

In the foregoing case the corporation showed "accounts receivable 6X dollars, cash 24X dollars, while its accounts payable are 40X dollars." There can be no doubt that the corporation was entitled to classification as a personal service corporation, but it is difficult to follow the reasoning under which it was held to be qualified and the reasoning in some of the cases which will be discussed hereafter, in which the items of accounts receivable and accounts payable are held to be evidences of dealing in something other than the services of the *principal stockholders*.

Holding companies.—

REGULATION. . . . . A corporation can not be considered a personal service corporation when another corporation (not itself a personal service corporation) owns or controls substantially all of its stock or when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise is owned or controlled by the same interests. (Art. 1524.)

LOSS OF SUBSIDIARY—HOW TAKEN UP BY PARENT COMPANY.—

RULING. In view of the fact that personal service corporations are not required to file consolidated returns, a profit realized or loss sustained by a personal service corporation, attributable to its ownership of stock in another personal service corporation, should be accounted for in the same manner as in the case of an individual stockholder.

Where the business of a personal service corporation results in an operating loss, such loss will be divided among the stockholders at the close of its taxable year in proportion to their respective shares, and will constitute an allowable deduction in their returns of annual net income. (C. B. 3, page 198; O. D. 581.)

1. What constitutes rendering of personal service?—

(a) SERVICES MUST BE RENDERED PRINCIPALLY BY THE STOCKHOLDERS.—

REGULATION. In order that a corporation may be deemed to be a personal service corporation its earnings must be derived principally from compensation for personal services rendered by the corporation to the persons with whom it does business. Merchandising or trading either directly or indirectly in commodities or the services of others is not rendering personal service. Conducting an auction, agency, brokerage or commission business strictly on the basis of a fee or commission is rendering personal service. If, however, the corporation assumes any such risks as those of market fluctuation, bad debts, failure to accept shipments, etc., or if it guarantees the accounts of the purchaser or is in any way responsible to the seller for the payment of the purchase price, the transaction is one of merchandising or trading, and this is true even though the goods are shipped directly from the producer to the consumer and are never actually in the possession of the corporation. The fact that earnings of the corporation are termed commissions or fees is not controlling. The fact that a commission or fee is based on a difference in the prices at which the seller sells and the buyer buys raises a presumption that the transaction is one of merchandising or trading, and it will be so considered in the absence of satisfactory evidence to the contrary. (Art. 1525.)

The foregoing regulation provides that if a corporation is in any way responsible to the seller for the payment of the purchase price, the transaction is one of merchandising or trading.

The Treasury cannot, by regulation or otherwise, change the law or, in the absence of clear statutory authority, lay down different tests for the determination of whether one is "trading as a principal" than the general law recognizes and applies. When Congress used the expression "trading as a principal," it will, under the most elementary rules of statutory construction, be presumed to have used it in its accepted legal sense.

The mere fact that one, who is in fact an agent, agrees to pay, or becomes otherwise responsible for, the debts of his principal, does not constitute him the principal; nor would it make him a "trader" in any true sense.

The Committee on Appeals and Review has held that a taxpayer who is engaged in the brokerage business is entitled to be taxed as one "not having more than a nominal capital" under the Act of 1917, even though it might be sued on the contracts which it entered into on behalf of its principals.[57]

The true test is whether or not a given corporation is *really* trading as a principal or simply acting as an agent. A number of facts and circumstances may enter into the determination of that question in any given case. One of these circumstances may very well be the fact that the corporation is responsible for the debts which it contracts, presumably on behalf of another, but that is not an inclusive or conclusive test. Nor, in view of the well-recognized rule of law, that under certain circumstances an agent may make himself personally responsible for the obligations of the principal—upon which the principal is also liable—without changing his legal status as an agent, can it be considered a very material one.

It will be noted that any agency or brokerage business conducted strictly on the basis of fees or commissions is deemed to be rendering personal service, but that any trading in commodities or the services of others is not rendering personal service. This is hardly consistent, because most brokers

[57] C. B. 4, page 20; A. R. R. 500. See page 836.

use the services of employees, in which case there is a trading in such services. The Treasury illustration quoted in *Excess Profits Tax Procedure*, 1921, pages 87, 88, deals with a corporation which renders engineering services and assumes an income of $60,000 therefrom. It may reasonably be assumed that the fees paid for services are for the services of others than the principal stockholders. The language of the statute would seem to be broad enough to include as personal service corporations those which trade in the services of others.

In specific cases the Treasury has held that corporations may not be taxed as personal service corporations in the following circumstances: if a corporation deals in the services of others who are connected with the corporation not through stock ownership but merely as employees in branch offices, etc.;[58] if a corporation assumes risks of market fluctuations, bad debts, etc., or if it guarantees or is in any way responsible to the seller for payment of the purchase price;[59] if the business conducted is a commercial enterprise;[60] if a freight-forwarding business advances the necessary costs of transportation for the concerns with which business is done;[61] if a so-called commission business takes title to the merchandise sold, is liable to the consignor and rebills the merchandise.[62]

A corporation which obtained "selling contracts covering lots, tracts and other parcels of land"[63] disposed of on a commission basis, claimed assessment under section 209 of the 1917 excess profits tax law, on the ground that it had only "nominal capital." It made no purchases on its own account and did not finance real estate operations. It had capital stock paid in of $2,000, and some earned surplus.

Ruling. . . . . The taxpayer contends that it requires and employs no more than a nominal capital in the conduct of its business, that the character of its business is such that capital is not required,

[58] C. B. 2, page 20; A. R. M. 59.
[59] C. B. 2, page 19; A. R. M. 50.
[60] C. B. 1, page 14; T. B. R. 58.
[61] C. B. 1, page 13; A. R. R. 7.
[62] C. B. 2, page 23; A. R. R. 23; and C. B. 2, page 20; A. R. M. 59.
[63] C. B. 4, page 17; A. R. R. 464.

and that its success is due to and its net income is derived solely from the activities of its officers, all of whom are stockholders. To this contention the Committee does not agree for the reason that it is shown that in the conduct of its business the corporation does require capital and that its income is derived in a large part from services rendered by others.

. . . . In view of the fact that the said corporation was ultra-conservative in its capitalization and the further fact that the amount of capital it had invested in the business was insufficient at times to meet the needs of that business and was less than normal as compared with the amount of business transacted and as compared with the amount of capital employed by other concerns doing a similar business, the Committee recommends that the case be returned to the Unit for adjustment and assessment of excess profits tax under the provisions of section 210 on the basis of the average percentages shown on the data sheet submitted to the Committee. (C. B. 4, page 17; A. R. R. 464.)

The following have been held by the Treasury to be personal service corporations and are taxed as such: a corporation which conducts a commercial school but does not take students as boarders, the principal owners of which devote all their time to preparation of courses, inspection of lessons, etc.;[64] a corporation whose business is the sale of real estate for clients and the collection of rents from property listed with it, whose entire income comes from commissions on business derived from the activity of the principal owners;[65] an agency which acts as consignee agent in the United States for a foreign corporation acquiring no title to the products handled but deriving its income from commissions on sales made by its principal stockholders.[66]

(b) The business must be conducted principally by the stockholders.—

Regulation. In determining whether a corporation is a personal service corporation, no weight can be given to the fact that it renders personal services unless (*a*) the principal owners or stock-

[64] C. B. 2, page 16; A. R. R. 24.
[65] C. B. 3, page 21; A. R. R. 210.
[66] C. B. 2, page 24; A. R. M. 420; and for a similar case see C. B. 4, page 20.

holders are regularly engaged in the active conduct of its affairs and are engaged in such a manner that the earnings are to be ascribed primarily to their activities, and (*b*) its affairs are conducted principally by such owners or stockholders. (Art. 1527.)

The statute does not require (and the Committee on Appeals and Review has so held) that the income shall be due entirely but only primarily to the activities of the principal stockholders. It has been recently decided by the Committee that a corporation doing a stevedoring business may be entitled to personal service classification.[67]

2. To what extent must the earnings be derived from services rendered by the stockholders?—

(a) A NON-PERSONAL SERVICE ELEMENT MAY BE PRESENT IF IT IS NEGLIGIBLE.—

REGULATION. It frequently happens that corporations are engaged in two or more professions or businesses which are more or less related, one of which does not consist of rendering personal service. Thus an engineering concern may also engage in contracting, which amounts to trading in materials and labor, a brokerage concern may guarantee some of its accounts, a photographer may sell pictures, frames, art goods and supplies, or a dealer in a commodity may furnish expert advice or services with respect to its installation, use, etc. In such case the corporation is not a personal service corporation unless the non-personal service element is negligible or merely incidental and no appreciable part of its earnings are to be ascribed to such sources. (Art. 1526.)

An advertising agency which is incorporated, the principal owners of which are personally engaged in the business, although capital is employed to carry the accounts of customers, should be classed as a personal service corporation. In such a case capital would be no more than incidental and would not be a material income-producing factor.

INCOME FROM MERE OWNERSHIP OF PROPERTY INVALIDATES CLAIM.—

RULINGS. A claim for assessment as a personal service corporation should be denied where the income of the corporation is derived entirely as a result of the ownership of certain property (such as

[67] Bulletin 41 21-1858; A. R. R. 463. See page 834.

patents) and is in no sense derived from the personal activities of any of the stockholders. (C. B. 1, page 13; T. B. M. 9.)

A sanitarium owned and operated by doctors, who in addition to selling their services derive income from the buildings and grounds by housing patients, can not be termed a corporation within the personal service class. (C. B. 1, page 15; O. D. 2.)

(b) Earnings are not derived from personal services if the principal duties of the stockholders are to supervise a force of employees.—

Regulation. Where the principal owners or stockholders do not render the principal part of the services, but merely supervise or direct a force of employees, the corporation is not a personal service corporation. If employees contribute substantially to the services rendered by a corporation, it is not a personal service corporation unless in every case in which services are so rendered the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the principal owners or stockholders and such fact is evidenced in some definite manner in the normal course of the profession or business. The fact that the principal owners or stockholders give personal attention or render valuable services to the corporation as a result of which its earnings are greater than those of a corporation engaged in a like or similar business, the principal owners or stockholders of which do not devote personal attention to the management or supervision of its affairs, does not of itself constitute the corporation a personal service corporation. (Art. 1528.)

Ruling. . . . . The Bureau has uniformly taken the position, and the Committee thinks correctly, that the business of stevedoring is primarily trafficking in the labor of others, and it therefore recommends that the action of the Unit in assessing tax under section 210 rather than under section 209 be approved. (C. B. 3, page 22; A. R. R. 213.)

That is to say, a corporation engaged *primarily* in the trading in labor of others should not be classed as a personal service corporation.

The Committee has held, however, that the following facts do not constitute general stevedoring business:

Ruling. A corporation, the stockholders of which are efficiency engineers in the stevedoring line, acts as consultants to general stevedores, and has a contract with a foreign government under which the longshoremen employed by the company receive the full amount for

their labor which was received by the corporation by way of advances from the foreign government to meet the weekly pay roll. The income is ascribed *primarily* to the activity of the sole stockholders. *Capital* is not a material income-producing factor. The corporation is therefore entitled to classification as a personal service corporation. (B. Digest 41-21-1858; A. R. R. 463.)

It is apparent in the foregoing case that the company had pay-rolls which implies "trafficking in the services of others" and that it depended on "advances" to meet the pay-rolls. Probably it was legally liable to the employees if the "advances" were not received. The company undoubtedly is a personal service corporation, but so are others similarly situated which have been denied the classification.

3. To what extent may capital be used to conduct the business?—

(a) Capital must not be a material income-producing factor.—

Regulation. In determining whether a corporation is a personal service corporation, no weight can be given to the fact that the invested capital of the corporation for the purpose of the war profits and excess profits tax or the actual investment of the principal owners or stockholders is comparatively small. The test established by the statute with respect to capital is entirely different. That test is the nature of the profession or business as indicated (*a*) by the kind of services it renders and (*b*) the extent to which capital is required to carry on such profession or business. If the use of capital is necessary or more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation. No corporation is a personal service corporation if it carries on business of a kind which ordinarily requires the use of capital, irrespective of whether the owners or stockholders have actually invested a substantial amount of capital. (Art. 1531.)

As stated on page 824, the law expressly permits the use of capital. The limitation is that it must not be material. The regulation is framed to *exclude* as many as possible notwithstanding the effort of the lawmakers to *include* all that can reasonably qualify.

Until recently the Income Tax Unit has held that the

mere fact that a company might be liable under an obligation should preclude a taxpayer from a classification of a personal service corporation.

The Committee has disposed of this point in a sensible way.

RULING. The M corporation was a broker in metals and employed only a nominal capital. No advances were made to the manufacturer and collections from the purchaser were only transmitted through the broker. Although the corporation was liable to be sued under its contracts with the purchaser the Committee considers that the nominal capital of the corporation clearly establishes the fact that it was contemplated it should not be held responsible except by way of personal service to both buyer and seller. Accordingly the Committee recommends that assessment of the excess profits tax be made in accordance with the provisions of section 209 of the Revenue Act of 1917. . . . . (C. B. 4, page 20; A. R. R. 500.)

(b) THERE MUST NOT BE A SUBSTANTIAL AMOUNT OF CAPITAL ACTIVELY EMPLOYED, WHETHER SECURED DIRECTLY OR INDIRECTLY.—

REGULATION. The term "capital" as used in section 200 of the statute . . . . means not only capital actually invested by the owners or stockholders, but also capital secured in other ways. Thus if capital is borrowed either directly as shown by bonds, debentures, certificates of indebtedness, notes, bills payable or other paper, or indirectly as shown by accounts payable or other forms of credit, or if the business of the corporation is in any way financed by or through any of the owners or stockholders, these facts will be deemed evidence that the use of capital is necessary. If a substantial amount of capital is used to finance or carry the accounts of clients or customers, it will be inferred that because of competition or other reasons such practice is necessary in order to secure or hold business which otherwise would be lost, and that the corporation is not a personal service corporation. If a corporation engaged in an agency, brokerage or commission business regularly employs a substantial amount of capital to lend to principals, to buy and carry goods on its own account, or to buy and carry odd lots in order that it may render more satisfactory service to its principals or customers, it is not a personal service corporation. In general the larger the amount of the capital actually used the stronger is the evidence that capital is necessary and is a material income-producing factor and that the corporation is not a personal service corporation. (Art. 1532.)

Generally speaking, the test is not the small amount of capital employed, but the nature of the business as indicated by the kind of services rendered, rather than by the extent to which capital is required. If capital is employed, but is not needed for the conduct of the business, the size of the capital alone would not prevent a corporation from being classed as a personal service corporation.

The test is, would the capital *without* the personal service element produce the income which has been earned?

To constitute a "personal service corporation" no definite percentage of stock need be held by those conducting the business.—

Regulation. No definite percentage of stock or interest in the corporation which must be held by those engaged in the active conduct of its affairs in order that they may be deemed to be the principal owners or stockholders can be prescribed as a conclusive test, as other facts may affect any presumption so established. No corporation or its owners or stockholders shall, however, make a return in the first instance on the basis of its being a personal service corporation unless at least 80 per cent of its stock is held by those regularly engaged in the active conduct of its affairs. (Art. 1529.)

The regulations do not require that at least 80 per cent of the stock of the corporation must be held by those regularly engaged in the active conduct of its affairs, but do stipulate that unless 80 per cent of the stock is so held the corporation must first make the corporation return and subsequently make application for the privilege of being classed as a personal service corporation.

Change of ownership does not take a corporation out of the personal service class.—

Regulation. The fact that the owners or stockholders of the corporation may change during the course of the taxable year does not take a corporation which is normally in the personal service class out of that class. Frequent changes in the ownership of any substantial interest or number of shares are, however, evidence bearing on the question as to whether the principal owners or stockholders are actively engaged in the conduct of the affairs of the corporation.

The incapacity, retirement, or death of a principal owner or stockholder who has been actively engaged in the conduct of its affairs will not be deemed to make any change in the status of the corporation during a reasonable time thereafter. (Art. 1530.)

Personal service corporation entitled to net loss provision.—If a personal service corporation shows a net loss for the year 1921, the same may under certain conditions be applied against the succeeding year.[68]

Credits allowed stockholders of personal service corporations.—

REGULATION. A stockholder of a personal service corporation is entitled to credit for the purpose of the normal tax only for amounts received in distribution of earnings or profits of the corporation accumulated since February 28, 1913, except such amounts as represent earnings of the personal service corporation accumulated after December 31, 1917, and prior to January 1, 1922, which would have been taxed directly to the stockholder. . . . . In addition to the credits ordinarily allowed to an individual, a stockholder of a personal service corporation is entitled relative to income properly allocated to the period beginning with January 1, 1918, and ending with December 31, 1921, to the following credits: (*a*) A credit against net income for the purpose of the normal tax only of his proportionate share of such dividends and interest allowed as credits by section 216 as are received by the personal service corporation, and (*b*) a credit against income tax of the stockholder's proportionate share of income, war profits, and excess profits taxes of the personal service corporation paid or accrued during the taxable year to a foreign country or to any possession of the United States, subject to the limitations of section 222 of the statute. (Art. 339.)

Foreign corporations cannot be classed as personal service corporations.—Even though a foreign corporation doing business in the United States derives all its income from the activities of its principal owners, it cannot be classed as a personal service corporation. Under 1918 and 1921 laws, all foreign corporations (whether personal service or not) are taxed under sections 327 and 328.

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[68] Section 204. See page 804.

Corporations with large government contracts may not qualify.—When 50 per cent or more of the *gross* income of a corporation is derived from "gains, profits, commissions or other income derived from a government contract or contracts made between April 6, 1917, and November 11, 1918," it cannot qualify as a personal service corporation.[69] This would include engineering and other corporations whose activities were devoted to government work during 1918.[70]

Corporations which do not distribute earnings may be classed as personal service corporations.—The attempt to impose in the 1918[71] law a penalty tax on the undistributed profits of all corporations was very properly defeated.

The 1921 law renews previous attempts to tax undistributed profits,[72] though by a somewhat different procedure. The new law provides that if the stockholders of a corporation, which is used to prevent the imposition of the surtax, "agree thereto, the Commissioner may, in lieu of all income, war profits and excess profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income," in the same manner as the partners of a partnership are taxed.[73]

Computation of tax when corporation is partly a personal service corporation.—Section 303 provides that if at least 30 per cent of the *net income* of a corporation is derived from a business, which if constituting its sole business would bring it within the class of personal service corporations, the tax upon that part of the income shall be computed separately. Such a corporation is subject to the excess profits tax (but not

[69] Section 200.

[70] For definition of government contract, see section 1, 1921 law.

[71] See Chapter XXXV for discussion of the 1917 law.

[72] Section 220. See Chapter XXXV

[73] **[Former Procedure]** Under the 1918 law (section 220) if a corporation was used to evade the surtax, the stockholders thereof were taxed in the same manner as stockholders of a personal service corporation. The stockholders had no right of election.

later than December 31, 1921, as of which date it is repealed). It should be noted on this point, however, that in computing the tax there must be ascribed to the personal service part of the business the same amount of capital which is normally required by corporations which have been deemed to be personal service corporations not subject to the excess profits tax.[74]

Status of stockholders in personal service corporation.—The surplus accumulated prior to January 1, 1918, by a corporation designated under the 1918 and 1921 laws as a personal service corporation, will have been subjected to the normal income taxes imposed between March 1, 1913, and December 31, 1917. The status of the surplus follows any transfers of shares of capital stock—that is, dividends declared before or after the transfer were free from the normal tax whether paid to a new or to an old stockholder. In 1921 the purchaser of shares of stock of a personal service corporation would certainly be free from the normal tax on dividends declared out of surplus accumulated prior to January 1, 1918, and would be free from the surtax as well on dividends declared from earnings accumulated after January 1, 1918, but prior to the current year.

Because of the fact that all earnings between January 1, 1918, and December 31, 1921, are subjected not only to normal tax but also to personal surtax, regardless of whether distributed or not, whereas only normal tax has been paid on the undistributed earnings accumulated prior to that date, it is important that the corporation's books show a clear line of demarcation between the surplus or undistributed profits accumulated respectively prior to and subsequent to January 1, 1918.

Ruling. A stockholder of a personal-service corporation having reported in his individual return for the taxable year his distributive share of the undistributed net income of the corporation for such

[74] See *Excess Profits Tax Procedure*, 1921.

taxable year should not again report such income when it is actually received in a subsequent year, neither will it be necessary to make any notation respecting such profits in the return for the subsequent year. (C. B. 1, page 174; O. D. 141.)

Personal service corporations should declare at once in dividends the earnings which have accumulated during the period January 1, 1918, to December 31, 1921. These profits have already been subjected to both the normal and surtax for these various years. If these profits are not declared in dividends, a personal service corporation will soon be in a position where the more recently accumulated profits must be declared in dividends before these "tax-free" profits may be withdrawn by the stockholders.[75]

Amended returns and claims when establishing personal service status.—

Ruling. A corporation filing returns on Form 1120 and subsequently desiring to establish its status as a personal service corporation should adopt the following method of procedure:

It should file amended returns on Form 1065 accompanied with claim for refund on Form 46 for the tax or installments thereof paid. The individual members of the corporation should also file amended returns accompanied with claims in abatement, Form 47, covering the additional assessment shown by such returns.

In the event that the corporation is found to be taxable under sections 230 and 301 of the Revenue Act of 1918, the claim for refund will be disallowed. In case the corporation establishes a personal service status, the claim for refund will be allowed for the tax paid by the corporation, and the claims in abatement will be disallowed and assessment made to the extent of the additional tax shown to be due on the amended individual returns.

Where the procedure is adopted, however, the installments of tax which become due prior to determination of the status of the corporation as shown by its return, as originally filed, must be paid on or before the due dates. Such installments are not subject to either abatement or credit, but can only be covered by supplemental claim for refund. (C. B. 3, page 198; O. D. 614.)

[75] For a detailed discussion, see page 713.

PART III

DEDUCTIONS

CHAPTER XXV

DEDUCTIONS AND CREDITS—GENERAL

Method of treatment.—The statute specifies the particular deductions and credits which may be subtracted from gross income to determine taxable net income or from the tax as ascertained under certain sections to determine the net tax to be paid. These deductions and credits are listed separately in the law and differ somewhat with the character of the taxpayer—whether a corporation, a personal service corporation or an individual, or whether a resident or a non-resident. In this book all the peculiarities relating to non-resident aliens, including deductions, are relegated to a special chapter (XXXVI). The deductions and credits allowed to others than non-resident aliens, whether individuals or corporations, are consolidated and are treated topically in the series of chapters which follows. This method of treatment is convenient because most of the deductions apply with equal force to individuals and corporations. Often the wording is exactly the same and in such cases repetition is avoided, for only one construction can be placed upon it. Where there is any variance in the deductions the fact is noted and the comments separated within the chapter, care being taken to make clear the limited application of the statements which relate only to corporations or only to individuals.

Since the law is printed in full in the Appendix and since all the provisions relating to deductions are quoted verbatim under the various individual topics in the succeeding chapters, it is not necessary to give here the various lists of allowable deductions. For these the reader is referred to sections 214 (a) and 234 (a) of the statute.

Deductions limited to those specified in the statute.—While the tax is levied on "net income received," that term is not

the usual "net income" of the accountant's vocabulary. It is a resultant obtained by subtracting from gross income, as determined in the particular manner described in the preceding chapters, certain specified deductions which are discussed in the chapters which follow. In the language of the regulations:

REGULATION. Net income is that portion of the gross income which remains after all proper deductions have been taken into account. The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals. . . . . (Art. 531.)

The law expressly excludes certain items usually regarded as legitimate deductions from income, and the Treasury has held that some other items of ordinary expenses are not allowable. Some of these restrictions apply both to individuals and to corporations. Others apply merely to one or the other. Neither individuals nor corporations, for example, may deduct special assessments of certain types or interest on money borrowed to purchase certain tax-exempt securities. On the other hand, an individual may deduct charitable contributions to a limited extent, while a corporation may not. Again, an individual may not deduct personal expenses, which makes it necessary to define personal expenses very carefully, while a corporation, of course, is presumed to have no "personal" expenses. Taxes imposed on an individual's residence and interest on money borrowed for personal use are not considered personal expenses. Moreover, under the 1918 and 1921 laws an individual can deduct the net loss sustained by any "casualty" which happens to his automobile or other property (such as a stock of liquors), a loss which is nothing more than a personal or living expense. Furthermore, individuals may deduct the interest paid on loans which are used to defray personal expenses. Inconsistencies such as these give rise to most of the complications encountered in drawing up returns. Those charged with the preparation of returns should carefully study

the provisions of the law bearing on deductions and be prepared to pass on the propriety of including or excluding the various items of expenditures which have been made.[1]

Deductions may be determined by accrual method.—

LAW. Section 212. . . . . **(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.** . . . .

Section 200. . . . . **The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212;** . . . .

If the taxpayer keeps no regular books of account, and if he does keep books, but on the basis of cash receipts and payments, he must claim his deductions on the basis of cash actually paid out. In all cases where it is possible to do so, the taxpayer should keep his books on an "accrual" basis. If this method, which is now specifically authorized by the regulations, is once adopted it must be followed in subsequent years. The application of the accrual method is thus described in the regulation:

REGULATION. (1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . . . (Art. 23.)

[1] The form of reconcilement statement which will be found in *Excess Profits Tax Procedure*, 1921, Chapter XV, affords a means of preventing the omission of any allowable deduction in the books, and as to classification it calls attention to any omission of allowable items not in the books.

Each year's return must be complete within itself.—

REGULATION. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. . . . (Art. 111.)

The foregoing principle is discussed in the chapters which follow. The intention is to impose no unreasonable restrictions on taxpayers who follow good accounting principles.

The new article omits the provision that losses from theft or embezzlement are deductible in the year of occurrence. This is in accordance with article 126.

RULING. Where a corporation engaged in buying and selling real estate purchases a piece of property and holds it for a profit, the interest, taxes, and ordinary repairs incident to the property represent charges for the year in which paid or are so charged upon the books as to represent liabilities of the corporation and are allowable deductions in computing net income even though in excess of the gross income derived from the property. Such charges are not capital expenditures if the corporation has any income from which to deduct them and they should not be added to the cost of the property in determining the amount of gain or loss arising from its sale except to the extent that the corporation has no gross income from any source against which to deduct such expenditures for the taxable year in which they were made. (C. B. 2, page 112; O. D. 398.)

The principle of each return being complete in itself is substantially modified by section 204 of the 1921 law, which allows net losses to be used to reduce the taxable income of the next two succeeding years. See Chapter XXIX.

Amended returns may be made to adjust items applicable to prior years.—

RULING. A corporation during its fiscal year ended May 31, 1919, sold certain goods, the weight and grade of which were guaranteed by contract. At the close of that fiscal year a number of claims involving shipments not conforming to specifications were in process of adjustment, settlement of which was made during the ensuing fiscal year.

Inasmuch as the corporation's liability is not in dispute and the amount thereof is merely an accounting detail to be determined under an existing contract or agreement and in accordance with a

recognized method of procedure the Committee is of opinion that such adjustments are applicable to the year in which the sales were made and hence properly deductible in the return of the corporation for its fiscal year ended May 31, 1919. (C. B. 3, page 147; A. R. R. 275.)

These regulations must be reasonably construed. All business concerns and all individuals have items of receipts and expenses which cannot be incorporated in books of account prior to closing time. In the well-managed concern the amounts are usually insignificant and when subsequently ascertained they are entered as current items in the succeeding period. If the amounts are large the treatment is different and adjustment of the accounts of the prior period and the filing of amended returns are in order, but after the accounts for a fiscal year are once closed there should be no reopening unless it is a matter of substantial importance.

This interpretation is apparently in accord with the general rule laid down in another regulation for the inclusion or exclusion of insignificant amounts in one year or another. It does not disturb the clear reflection of income.

Regulation. . . . . The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it. (Art. 22.)

The regulation quoted on page 109 (article 111) makes it plain that the taxpayer may file amended returns on his own initiative. The Commissioner, in turn, may on his part require such returns.

Regulation. . . . . If in the opinion of the Commissioner such information indicates that the returns for any previous years did not reflect the true income, amended returns for such years will be required. . . . . (Reg. 45, Art. 23.)

It is the desire of the Treasury to obtain returns which accurately reflect for a given year the actual income and the actual expenses applicable to that year. The Treasury accepts or requires amended returns, if based on meritorious grounds, whether or not the outcome is favorable to the government. The action of some inspectors would lead one to believe that amended returns are in order only when the net result is against the taxpayer, but the responsible officers of the Treasury maintain no such attitude.

Desirability of good records.—Most individuals keep poor accounts or none at all. It is desirable from almost every point of view to keep careful financial records, and the income tax levied at the present high rates makes it almost imperative that this be done. It is important from the point of view of the government in order that no taxable items may be missed. It is important from the point of view of the individual in order that his burden may not be inequitably large as compared with his neighbor's. But since most individuals find it easier to recall all the items of their income than of their expenditure, they usually do not avail themselves of all allowable deductions. In other words, the keeping of careful records in this case will work out more to the advantage of the taxpayer than to that of the government; but it will also result in the tax being more equitably spread, which is an advantage from every point of view.

Accounts of partnerships and corporations are, as a rule, better kept than those of individuals. They are, of course, supposed to include all items which can be claimed as allowable deductions. The items disallowed by the law and regulations are discussed in detail in the chapters which follow. If the accrual method is used all items of deductions, minus those specifically forbidden, as taken from the record of expenses or liabilities, should yield the proper result. If the accrual method is not followed, the taxpayer must depend upon his cash account.

CHAPTER XXVI

DEDUCTIONS FOR EXPENSES

General

The 1921 law re-enacts the provision of the 1918 law regarding deductions for expenses. The new law specifically permits individuals to deduct traveling expenses.[1]

The chief problems of procedure connected with deductions for expenses are occasioned by the presence of certain restrictions in the law itself. First of all, the statute forbids the deduction of personal living expenses.[2] This is quite necessary and proper, but it involves the difficult task of establishing a sharp line of demarcation between business and living expenses. Gifts,[3] in the next place, are not generally deductible; but in many cases it is not easy to determine whether a payment, nominally a gift, is not more truly an expense. The law does not permit the deduction of capital expenditures except in the form of depreciation allowances, and here once more it is necessary to set up a series of distinctions between this type of expenditures and business expenses proper. Again, care must be taken not to allow any distribution of profits under the guise of business expense. Other difficulties are caused by the prohibition of certain expenditures as contrary to public policy and by the necessity of taking a position on the question of insurance—as to how far expenses are deductible which seek to safeguard the income from risks of various sorts.

In this chapter the first general section is devoted to the

[1] See page 864.

[2] This rule is considerably modified if section 214 (a-6) (allowing for losses arising out of casualties) is interpreted to cover ordinary accidents to personal property, the use of which has always been regarded as private or family expense.

[3] See Chapter XXXIV, "Deductions for Gifts and Donations."

establishment of the distinction between business and personal expenses and is consequently applicable to individuals only. The remainder of the chapter deals with various specific types of expenses and, unless otherwise specified, applies alike to individuals, partnerships and corporations. In the case of many of these expenses the deductibility of a particular item becomes a complicated question involving several of the distinctions referred to in the preceding paragraph, as, for example, when a salary must be shown to be not a gift, a personal expense, a distribution of profit, a distribution of assets or a payment for property.[4]

Expenses which are deductible.—

LAW. Section 214. [Individuals] (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;[5]

. . . .

Section 234. [Corporations] (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for per-

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[4] See page 870.

[Former Procedure] Sections 214 (a-1) and 234 (a-1) of the 1921 law are identical with those in the 1918 law, except for the addition of the provision in the former relating to traveling expenses.

1916 LAW. Section 5. [Individuals] "(a) . . . . First. The necessary expenses actually paid in carrying on any business or trade, not including personal, living, or family expenses;"

Section 12. [Corporations] "(a) . . . . First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, ..."

[5] For comment on last two lines which were added by the 1916 law, see Chapter XXVII, "Deductions for Interest."

sonal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

The principle underlying the deductions for expenses was well expressed in a ruling under the 1913 law, as follows:

RULING. Only those expenses which are incurred in earning income which is subject to tax under the income tax law constitute allowable deductions in computing net income taxable under the law. (T. D. 2137, January 30, 1915.)

In general, there has been adherence to the foregoing principle. In some cases, however, expenses which have been incurred in earning taxable income have not been allowed.

Restrictions on expense deductions.—The restrictions on deductions for expenses are the following:[6]

LAW. Section 215. [Individuals] That in computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;[7] or

(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.[8] . . . .

Section 235. [Corporations] That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

Accrued expenses may be deducted.—When the accounts of a taxpayer are kept on the accrual basis all expenses incurred to the end of the taxable year, whether paid or not are

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[6] [Former Procedure] These provisions are identical with those of the 1918 law.

[7] See Chapter XXXI, "Depreciation."

[8] See page 894.

allowable deductions and should be entered in the books. It is, however, most reprehensible to enter accrued items of expenses unless all items of accrued income are also entered.

The term "expenses . . . . incurred" must be taken in its usual commercial sense. It would be improper for a concern to enter as an accrued expense at the end of the taxable year any items of which the business had not received the benefit. An office telephone company sent out notices on December 27, 1918, to the effect that the signing of a contract for its service was sufficient to warrant the inclusion of the liability thereby incurred as an allowable expense in the 1918 accounts. The statement was incorrect. In the first place, if the equipment was a capital expenditure it could not be deducted as an expense, and, in the second place, if it was an allowable expense item it should not be allowed until the business received the benefit, which could not occur before the year in which the service was actually installed.

Business Expenses Distinguished from Personal Expenses

Definition of "business or trade."—The law specifies that an individual must not include "personal, living or family expenses" in his computation of deductible expenses. He may subtract under this head merely "the ordinary and necessary expenses paid or incurred . . . . in carrying on any trade or business."[9] "Business" and "trade" are used synonymously and have been defined as follows in an old regulation:

RULING. That which occupies and engages the time, attention and labor of anyone for the purpose of livelihood, profit or improvement; that which is his personal concern or interest; employment, regular occupation, but it is not necessary that it should be his sole occupation or employment. (T. D. 1989, June 2, 1914.)

It is apparent that this definition is broad enough to include professions of all types,[10] as well as various avocations

[9] Section 214 (a-1).

[10] The excess profits tax law of October 3, 1917, specifically included professions within the definition of "trade" and "business." (See section 200.)

and "side-lines."[11] Moreover, it is not necessary for a person to own a business in order to be in business or to have business expenses. Salaried officers and employees and persons receiving their remuneration on a commission basis often have business expenses which are necessary and are allowable as deductions. Recognition of this is found in the original edition of Regulations 45.[12]

REGULATION. . . . . Amounts paid from a salary received for all services rendered and expenses incurred are deductible as business expenses when the expenditures are occasioned by the services in respect of which the salary is paid. . . . . (Reg. 45, Art. 292.)

In the April 17, 1919, edition of the regulations the statement was omitted. The omission, however, cannot operate to deprive anyone of a deduction for business expenses which the law permits.

The circumstances of each case are considered by the Treasury in deciding whether expenditures are business or personal. Office rent paid by a taxpayer whose income is derived principally from investments, is deductible if it can be shown that such rent is ordinary and necessary.[13] Expenses incurred in making a trip to Washington in connection with the assessment of additional tax by the Treasury have been held to be deductible.[14] Rental of a safe deposit box is held to be deductible only when used in connection with trade or business.[15]

"Personal expenses" defined.—In a case involving the question, whether or not transportation paid by a commuter is a deductible expense, the solicitor has very aptly defined personal expenses.

RULING. . . . . "Business expenses," as defined in article 101, Regulations 45, includes all items entering into what is ordinarily

[11] See C. B. 4, page 119; O. D. 805.

[12] The preliminary edition of these regulations was issued soon after the enactment of the 1918 law.

[13] C. B. 4, page 123; O. D. 877.

[14] C. B. 4, page 123; O. D. 849.

[15] Telegram to Guaranty Trust Co., signed by Commissioner Wm. M. Williams, dated March 8, 1921.

known as the cost of goods sold, together with selling and management expenses. In short, every necessary item of expense in conducting business, incurred primarily because of and solely in the furtherance of the business engaged in, is held to be an ordinary and necessary business expense.

To what extent can this definition of business expenses be applied? Does it include any and all expenses which in any way bear upon or have a relation to or a connection with the business engaged in by the individual? Obviously, amounts paid out for medical attention necessary for the upkeep of the body and the preservation of health are personal and have no connection with business. Likewise, sums paid to the grocer, to the tailor, amounts paid for insurance and house rent. These expenses arise independently of business. The test, therefore, is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure.

. . . . Obviously, an individual is free to fix his residence wherever he chooses. He fixes it according to his personal convenience and inclinations, as a matter separate and apart from business. Any expense, therefore, incident to such residence as fixed by the individual is a matter personal to him. . . . .

It is therefore held that the cost of transportation paid by a salaried employee living at a distance from his employment, in order to go to and return from such employment, is not deductible as a business expense within the meaning of the Revenue Acts of October 3, 1913, September 8, 1916, as amended, and February 24, 1919. (C. B. 1, page 101; S. 1048.)

The foregoing ruling holds that traveling expenses, when incurred in connection with a taxpayer's duties, are allowable deductions. The ruling is sound. It is difficult, however, to distinguish between occasional and frequent business expenses. If trips were made monthly, apparently the expense would be allowed; when trips are made daily the expense is not allowed. The principle does not seem to be logical. It would seem to be more logical to confine "personal, living and family expenses" to those which are expended whether or not a person is in business. If a person engages in business and is required to incur business expenses, the additional cost should be treated as a deduction from gross income. The solicitor (in Opinion 1048) falls into an error when he states that "obviously an individual is free to fix his residence wherever he chooses." In the case of the Congressman's secretary he

was required to fix it in Washington.[16] Only when one enjoys a "lazy" income is one free to live where one likes. The author would like to see a court decision on the deductibility of the commuters' railroad fares.

Theory underlying the segregation of business expenses.— In the opinion of the author the exact line between personal and business expenses can be determined with theoretical accuracy by ascertaining whether or not the various items would have been expended had the taxpayer's income been derived from some source, other than business, which required no outlay for business expenses. For example, if a salesman or other employee receives a salary of $3,000 per annum, the query should be propounded: "What would his personal, living or family expenses be if his income of $3,000 were derived from investments?" Theoretically he should be permitted to deduct any additional expenses incurred over and above those which he would pay if he were free to live wherever he chose and in any manner he chose within the limitations of his $3,000 investment income. If in order to earn his salary he must purchase books, attend lectures and incur similar expenses, they should be proper deductions. If he must belong to a luncheon club and entertain at his own expense prospective or actual customers, the dues and other charges of the club should be considered as business expenses and therefore as allowable deductions. If, to be within reach of his place of business, he must live in a community where rents are high, this additional amount should be considered a business expense, as should also the cost of his commutation ticket on the railway.

There are, however, apparent difficulties in applying in practice the theoretical distinction worked out in the preceding paragraph. Moreover, the specific provision of the law forbidding the deduction of actual "personal, living or family expenses" complicates the situation, for, as a matter of

[16] See ruling (C. B. 4; O. D. 865), page 865.

fact, items which would ordinarily be classified as "family" and "personal" expenses (such, for example, as house rent) may be and often are at the same time true business expenses as ascertained by the test given above. The law forbids the deduction of the higher rent which A pays to be near his work and the regulations forbid the deduction of the commutation fare of B who prefers to spend time and railway fare rather than rent in order to secure accessibility to his business.[17] Theoretically both deductions should be permitted. To work out a complete solution it is necessary both to change the law, in order to recognize certain "living" expenses as business expenses, and to liberalize the present regulations.[18]

Importance of precise distinction.—The importance of distinguishing carefully between business and personal expenses and of securing a full deduction of the former is greatly emphasized by two elements in the situation. The first is that "unearned" income, which at present is taxed at the same rates as business income, often has no business expenses attached to it and consequently runs no danger of excessive taxation through failure to deduct such expenses. If business

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[17] See ruling, page 865.

[18] The situation has been partly met in England by the establishment of allowances roughly equivalent to annual business expenses of this sort which are difficult to determine exactly, a practice permitted under the following section of the British Act of 1918 (8 & 9 Geo. 5, C. 40):

"Where the Treasury are satisfied with respect to any class of persons in receipt of any salary, fees, or emoluments payable out of the public revenue that such persons are obliged to lay out and expend money wholly, exclusively, and necessarily in the performance of the duties in respect of which such salary, fees, or emoluments are payable, the Treasury may fix such sum, as in their opinion represents a fair equivalent of the average annual amount laid out and expended as aforesaid by persons of that class, and in charging of the tax on the said salary, fees, or emoluments, there shall be deducted from the amount thereof the sums so fixed by the Treasury; provided that if any person would, but for the provisions of this rule, be entitled to deduct a larger amount than the sum so fixed, that sum may be deducted instead of the sum so fixed." (Sch. E, Rule 10.)

It may be that a fairly satisfactory solution of the problem in this country can be found by following the lines suggested in this law.

expenses are not completely deductible, business income stands at a still greater disadvantage, as compared with funded income, than is intended when the rates on both earned and unearned incomes are the same. In the opinion of the author the failure to tax unearned income at a higher rate than earned income in itself constitutes a sufficiently great discrimination without adding to it in this manner. The other element which emphasizes the desirability of carefully segregating business expenses is the fact that the average citizen of the United States is not given to a close analysis of his personal expenditures. He thus is apt to be taxed excessively, unless his attention is called to the importance of accurate accounts. Moreover, knowledge of one's personal expenditures undoubtedly leads to greater economy and increased savings. This, in turn, means larger amounts available for future income taxation, a fact which should not be overlooked by taxing authorities in framing regulations governing deductions for expenses.

Suggestion for segregating business expenses.—Where business expenses are intermingled with personal expenses, it is sometimes helpful to approach the problem in a negative fashion—that is, to ascertain first the amounts paid for personal, living and family expenses (items which are *not* deductible) and to assume tentatively that the remainder represents business expenses. With such an assumption in mind the examination of the charges composing this remainder often reveals deductible items not otherwise apparent.[19]

In the paragraphs which follow various items officially classified are cited as illustrative of allowable deductions. So long as good faith is observed in the inclusion of an expense item, it is not likely to arouse objection.

[19] The remainder, determined in the negative manner thus described, would, of course, not be an item acceptable to the tax authorities. The suggestion is made merely as a method of discovering deductible items which can be consolidated into a positive total of business expenses, suitable for use in the return.

May personal expenses be deducted as casualties?—Section 215 provides that "no deduction shall in any case be allowed in respect of (a) personal, living or family expenses." But under deductions this statement appears:

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(6) Losses, sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise; . . . .

It is claimed that the allowable deduction for a casualty to property "not connected with the trade or business" would extend to net losses sustained on private automobiles. If so, the deduction would also extend to the breakage of statuary and ornaments in one's home, to eyeglasses and perhaps to children's toys.

The author is of the opinion that section 215 is controlling as to all items which the taxpayer ordinarily regards as "personal, living or family expenses," and therefore section 214 (a-6) includes only losses arising from such casualties as could not be regarded as personal, living or family expenses.

If a residence burns down, the loss not covered by insurance is deductible. The test should be whether or not there has been a property loss, and no deduction should be permitted which cannot reasonably be so construed. In most cases taxpayers have three classes of expenditures: (1) expenses connected with business or trade; (2) expenses involved in investments and transactions entered into for profit; (3) personal, living or family expenses. Losses arising out of class (2) are fully deductible under the 1921 law. The residences of taxpayers may be said to be in a class by themselves, but items which the taxpayer himself has always regarded as in class (3) should not be taken out of that class except for a sound economic reason. The author does not believe that such a reason exists.

While it can hardly be said that the wording of the sec-

tions is ambiguous, yet the intention of the framers of the law is an important factor, and it may be assumed without investigation that there was no intention on their part of completely reversing all former procedure and permitting the deduction of such an item as a loss arising from the puncture of an automobile tire.

Wages for personal service.—The law does not permit a deduction for wages paid to those in domestic service, nor to those, such as dressmakers and others, who produce articles consumed in the taxpayer's family, but wages paid to those who help to produce the income may be deducted. This rule is broad enough to include in most cases the salary of a private secretary. The distinction drawn in the 1918 edition of the *Income Tax Primer* is suggestive:

RULING. I employ a man to assist me in operating my farm and a woman to assist about the house. Is the compensation paid to each allowable as a deduction?

Unquestionably, as to the amount paid to the male employee, but a line must be drawn as to the amount paid to the female employee. If her time is employed entirely in taking care of milk and cream produced for sale, in the production of butter, cheese, etc., the care of milk cans and churns, or, if a separate table is maintained for laborers employed on the farm and her services are used entirely in the preparation and serving of the meals furnished the laborers and in caring for their rooms, the compensation paid her constitutes an allowable deduction. If, however, she is employed to assist in caring for the farmer's own household, no deduction can be claimed. (*Income Tax Primer,* 1918, question 60.)

Wages paid to children.—

REGULATION. . . . . The father is legally entitled to the services of his minor children, any allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. . . . .[20] (Art. 291.)

The 1918 edition of the *Income Tax Primer*, in addition to

[20] **[Former Procedure]** Article 8 of Regulation 33, 1918, reads: "As a rule, allowances which he gives them . . . . are not allowable deductions . . . ." The present regulation is more emphatic in the denial of this item.

affirming the above rule, makes the positive statement that compensation paid to a child who has attained his majority may be deducted if of the nature of a business expense.[21]

Under the British practice, if any of the children or other relatives, except the wife, of a trader earn their livelihood in his employ, and if the trader provides their board and lodging as part of their remuneration, the expense thereof may be charged in his accounts as a trade expense irrespective of the age of the employee. On the other hand, if he withdraws some of his goods for domestic use, he should make an allowance therefor in his return of income.

Business expenses of the professional man.—Many lawyers, doctors and other professional men keep fairly accurate records of income, but are not careful to separate personal and living expenses from those incurred in producing their income. If care is taken to assemble all items of taxable income, equal care should be taken to compile a schedule of allowable deductions from income.

The official procedure in deducting professional expenses is outlined in the regulations in this language:

REGULATION. A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid for office rooms, the expense of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistants. Amounts currently expended for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted.[22] . . . . (Art. 104.)

Under this new article professional men may deduct current expenditures for books, etc., if the life of such articles is short.

RULING. Expenses incurred by doctors in taking post-graduate courses are deemed to be in the nature of personal expenses and not deductible. (B. 31-21-1755; O. D. 984.)

[21] *Income Tax Primer,* 1918, question 61.

[22] See pages 868, 869.

Expenses incurred by school teachers attending summer school have been held to be personal.[23] A professional singer may not deduct amounts paid to a specialist in the care of his throat.[24]

Depreciation on property "of a permanent character."—Property "of a permanent character," expenditures for which may not be deducted as business expenses, is, of course, subject to depreciation. Earlier rulings specifically stated that depreciation allowances might be claimed for it.[25]

In order to secure the benefit of the deduction of the entire cost in the case of such items as professional books it is necessary merely to ascertain the aggregate cost of such books and to spread the cost over their effective or serviceable life. If a technical book is obsolete at the end of one year the depreciation allowance for the year will be its whole cost. Roughly speaking, after a library is once established the cost of additions is probably less than actual depreciation; therefore it will probably work to the advantage of the taxpayer to be precise in dealing with this item. But substantial justice will be done to the government and taxpayer alike if the ordinary purchases of professional and business books are treated as necessary expenses and the question of depreciation is ignored.

When office is in rented residence.—In case a professional man lives in a rented house and uses a portion of it for professional or business purposes the Treasury holds that the proportion of the rental paid which is chargeable to the rooms so used may be deducted as a business expense.

Regulation. . . . . In the case of a professional man who rents a property for residential purposes, but incidentally receives there clients, patients, or callers in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house

[23] C. B. 4, page 209.
[24] B. 37-21-1819; O. D. 1032.
[25] *Income Tax Primer*, 1918, question 59.

for his office, such portion of the rent as is properly attributable to such office is deductible. . . . . (Art. 291.)

The above ruling, refusing to permit the deduction of a portion of the rent of a residence used partly for business purposes in case "the place of business" is elsewhere, appears to raise the question as to whether or not a professional man may have more than one place of business. The regulation apparently assumes in the phrase, "the place of business being elsewhere," that he can have only one place of business. As a matter of fact he may have several. In case the expenses of the additional quarters are "necessary" to the practice of the profession, they are certainly deductible under the law.

When office is in owned residence.—No definite ruling appears to have been issued covering the case of the professional man who owns his residence and uses part of it as his place of business, but there is no doubt about the propriety of deducting in such a case the proper proportion of the depreciation, repairs, fuel, light, water, telephone, etc.

Traveling expenses.—

Law. Section 214. [Individuals] (a) That in computing net income there shall be allowed as deductions:

(1) . . . . traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; . . . .

Regulation. Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, such railroad fares are personal expenses and such meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, become business instead of personal expenses. (*a*) If, then, an individual, whose business requires him to travel, receives a salary as full compensation for his services, without reimbursement for traveling expenses, or is employed on a commission basis with no expense allowance, his traveling expenses, including the entire amount expended for meals and lodging, are deductible from gross income. (*b*) If an individual receives a salary and is also repaid his actual traveling expenses, he shall include in gross income the amount so repaid and may deduct such expenses.

(*e*) If an individual receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, the amount of the allowance should be included in gross income and the cost of such meals and lodging may be deducted therefrom. A payment for the use of a sample room at a hotel for the display of goods is a business expense. Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. A taxpayer claiming the benefit of the deductions referred to herein must attach to his return a statement showing (1) the nature of the business in which engaged; (2) number of days away from home during the taxable year on account of business; (3) total amount of expenses incident to meals and lodging while absent from home on business during the taxable year; (4) total amount of other expenses incident to travel and claimed as a deduction.

Claims for the deductions referred to herein must be substantiated, when required by the commissioner, by records showing in detail the amount and nature of the expenses incurred.

Commuters' fares are not considered as traveling expenses and are not deductible. [Art. 101 (a).]

The 1921 law merely confirms a deduction which under any reasonable interpretation was fully allowable under all previous laws. Under the 1918[26] and prior tax laws, the regulations provided that the amount expended as business traveling expenses should be reduced by any saving of personal expenses, the reduced amount being a proper deduction from gross income. To properly determine any saving was a difficult task and a great inconvenience.

RULING. Amounts expended during the taxable year by a secretary to a Member of Congress and by his assistants for railroad fares, in making trips from their homes to Washington and return in connection with their duties, may be claimed as a deduction in computing their net income. Such expenditures incident to trips made for purely personal reasons are not deductible. (C. B. 4, page 212; O. D. 865.)

Any expenditures for traveling other than in the pursuit of a trade or business are not deductible under any of the tax laws.

If a taxpayer who claims, say, $500, for five trips from New York to Chicago and return during 1921 is called upon

[26] **[Former Procedure]** See Art. 292, Reg. 45, as amended by T. D. 3146. See *Income Tax Procedure*, 1921, pages 672, 673.

for proof, it would probably be a sufficient compliance with the law to prepare an affidavit setting forth that the trips were exclusively on business, that the railroad fares were so much and that meals and other necessary expenses averaged so much a day. The test will be, what a jury would allow, and it would not be necessary to produce vouchers because good business practice does not call for the securing of receipted bills for meals and similar expenses. The Treasury Department, however, is strict in requiring detailed information and will disallow deductions which cannot be reasonably supported. Compromises will apparently not be made.[27]

RULING. A taxpayer engaged in a business in 1917 and 1918 which required him to spend a part of his time away from home but who failed to furnish the detailed information called for in article 292 of Regulations 45, 1920 edition, although requested to do so, is not entitled to claim as a deduction expenses incurred for meals and lodging in connection with carrying on such business. Treasury Decision 3101 amending article 292, Regulations 45, has been superseded by Treasury Decision 3146 (Regulations 45, 1920 edition), in which no mention is made as to the effective date of the provisions of article 292. (B. Digest 29-21-1735; A. R. R. 572.)

EXPENSES REIMBURSED MAY BE IGNORED IN RETURNS.—Traveling or other expenses incurred in rendering services by the taxpayer, which are afterward refunded to him should be included in gross income and deduction claimed for actual expenses. [See article 101 (a).]

TRAVELING EXPENSES WHICH ARE NOT DEDUCTIBLE.—

RULINGS. A Member of Congress may not deduct expenses incurred in making trips of a personal nature to and from Washington, the expense of taking members of his family to or from Washington, living expenses while in Washington, or campaign expenses. (C. B. 4, page 211; O. D. 864.)

Living expenses paid by a single taxpayer who has no home and is continuously employed on the road may not be deducted in computing net income. (C. B. 4, page 212; O. D. 905.)

. . . . Where a man makes a contract of employment with an employer in this country, and upon completion of such con-

[27] I-2-19; A. R. R. 719.

tract he makes a second contract with another employer in a foreign country, without allowance for travel expenses, the expenditure incurred in reaching such place of employment cannot be considered as an expense incurred in furtherance of a trade or business, but rather as an expenditure to fulfill a condition precedent to such employment in a trade or business and is therefore regarded as a personal expense and not deductible. The test is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure. (C. B. 2, page 157; O. D. 451.)

The foregoing ruling is questionable. The expense is not the same as that of a commuter. The gross amount of the compensation to be collected in the foreign country is taxable. The cost of getting there arises from the income and would seem to be directly connected with that income. It is not a pleasure trip, but purely a business trip. If a business trip, the cost must be a necessary business expense and allowable under the law. In principle this expense is just as properly deductible as the expenses of a Congressman's secretary.[28]

Personal expenses of army officers and government officials.—

Regulation. . . . . The cost of the equipment of an army officer to the extent only that it is specially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not.[29] (Art. 291.)

Ruling. Any amounts expended in purchasing furnishings and maintaining the residential portion of an embassy are considered personal expenses. Amounts expended in entertaining are likewise considered personal expense. While it is recognized that ambassadors do a certain amount of entertaining, Congress does not require it as one of the duties of the position or make specific appropriations for

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[28] See ruling (C. B. 4, page 212; O. D. 865), quoted on page 865.

[29] **[Former Procedure]** The above ruling reverses the procedure formerly in force. The previous practice, which operated very unfairly was prescribed in the following language:

Regulation. The pay and allowance of army officers are based on the obligation of an officer to provide equipment and mounts as a personal expense. The cost of mounts and equipment is not therefore a deductible expense. (Reg. 33, 1918, Art. 8.)

For detailed criticism of this regulation see *Income Tax Procedure*, 1919, page 411.

such entertainment. It is held that such expenditures are personal expenses and not business expenses, and are therefore not deductible. (B. 36-21-1802; O. D. 1020.)

The foregoing ruling is not sound. The author hopes that it will be questioned by someone who, in order to properly perform his duties, has expended part of his salary for other than personal or family expenses. A business man deducts, and properly so, all similar expenses.

Clothing and personal equipment as a business expense.—Wherever clothing and other equipment, such as the uniforms and instruments of musicians, constitute business expenses because not adaptable to private use, the cost thereof is an allowable deduction. To the extent that uniforms serve to diminish one's living expenses no deduction is proper, but if an additional expense is incurred solely to enable one to earn a living, this cost is nothing more or less than a necessary business expense.

This rule is in harmony with the regulation regarding actors' costumes.[30]

Automobiles used in part for business purposes.—

Ruling. The Committee is unable to distinguish any essential difference between expenses incurred in travel by railroad and those incurred in travel by automobile, where such travel by either conveyance is undertaken solely on account of business interests and not for the personal pleasure of the taxpayer. Since railroad fares paid in connection with business trips are deductible as a necessary expense of the business, the Committee sees no reason why the expense of such trips, when made by automobile, should not fall within the same category.

It is therefore the opinion of the Committee that such portion of the upkeep and operating expenses of a taxpayer's automobile as was occasioned by its use in the taxpayer's business is properly deductible as a business expense in the return of such taxpayer. . . . . (C. B. 3, page 131; A. R. R. 266.)

Perhaps the item of expense most difficult to apportion between living and business is the upkeep of an automobile

[30] See Chapter XXXI.

which is used both for business and for personal purposes. The test is apparently simple enough. "Personal, living or family" expenses are not allowable deductions. Business expenses are allowable deductions.

In the application of the test, however, interesting problems sometimes arise. Often the apportionment is easily established, because the facts as to the relative use for the two purposes are clear; but in other cases the whole theory of what is business expense as compared with living expense is involved. For instance, a clerk lives some distance away from his place of employment. It takes him an hour to make the trip each way. He purchases an automobile and cuts down the time one-half. Is the upkeep of the automobile a necessary business expense? If he sleeps a half-hour longer each morning and reaches home a half-hour earlier each afternoon the automobile expense would appear at first glance to be 100 per cent personal. But suppose the added leisure increases his efficiency during work hours. Or suppose he spends an hour more each day at work and earns more money, all of which is taxable. On either of the last two suppositions that part of the automobile expense which is fairly chargeable to the daily trip would seem to be a reasonable and proper business expense. Of course, the refinement cannot be carried beyond the point of practicability, and it must be admitted that administrative control of such deductions is difficult. If the deduction cannot stand the test of reasonableness, it should not be claimed.

Premiums on certain insurance a personal expense.—

REGULATION. Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense and not deductible. Premiums paid for life insurance by the insured are not deductible. . . . . (Art. 291.)

RULING. Premiums paid by a taxpayer on insurance taken out under the War Risk Insurance Act, whether or not the insurance is subsequently converted, are not deductible in computing net income under the Revenue Act of 1918. (C. B. 4, page 208; O. D. 828.)

Alimony and damages for breach of promise are personal expenses.—

REGULATION. . . . . Alimony and an allowance paid under a separation agreement are not deductible from gross income. . . . .[31] (Art. 291.)[32]

Expenses incurred on account of a partnership.—

RULING. By the terms of a partnership agreement one of the members of the partnership is required to pay out of his own funds the compensation of one of the employees of the partnership who performs a part of the duties delegated to said member.

Held, that the amount so paid constitutes a proper deduction in the income tax return of the member under section 214 (a) 1 of the Revenue Act of 1918. (C. B. 4, page 137; O. D. 947.)

The above ruling under the 1918 law reverses a decision made by the Treasury under the 1917 law, wherein business expenditures by an individual made in behalf of the partnership were not allowed.[33] All expenses incurred by a partner in the furtherance of a partnership of which he is a member (for which he has not been reimbursed) are deductible as being necessary business expenses. Certainly if such expenditures are made for the purpose of promoting his interest in the firm, it cannot be said that they are personal expenses.

Salaries, Wages, Commissions and Similar Compensation

The authority for deducting salaries and wages is found in the following section of the law:

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . . .

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[31] *Gould v. Gould,* 245 U. S. 151, 38 S. Ct. 53, 62 L. Ed. 211.

[32] See page 367.

[33] C. B. 3, page 130; O. D. 593.

Meaning of phrase "including a reasonable allowance for salaries."—The author has always contended[34] that the Treasury has no power to decide whether the salaries paid in good faith by corporations to their officers are reasonable or otherwise. In the past the Treasury has attempted to determine on an arbitrary basis how much of the salary paid to a particular officer was "reasonable" and has tried to disallow the deduction of anything in excess of the amount.

The author's position on this matter, namely, that a salary payment is not subject to review by the Treasury, unless part of the payment is not really salary but a distribution of profits or assets, has been completely upheld by the courts in 1921. An appeal was taken by the Treasury in the Philadelphia Knitting Mills case[35] (quoted in *Income Tax Procedure,* 1921) and a decision was handed down on June 13, 1921, by the United States Circuit Court of Appeals for the Third Circuit.[36]

The court said:

DECISION. In view of the proceedings below the question involved in the case is somewhat elusive. In our examination of these proceedings we find really two questions, one raised by the Government and seemingly abandoned; the other raised by the court and ruled on.

The question on which the Government seeks the opinion of this court is: Has the Government the right, under the cited provision of the Corporation Excise Tax Act of August 5, 1909, to inquire and determine whether a salary, paid by a corporation and deducted in its return as an "ordinary and necessary" expense, is reasonable and fair compensation for the services rendered, and thereupon to revise the return and limit the deduction to what it considers a reasonable salary; and, in the event of dispute, to have a jury pass upon and decide the same?

Such a power in the Government, if it exists, must have been conferred by the statute. The statute provided for a tax at a named rate upon the net income of a corporation, to be ascertained by deducting from its gross income "all ordinary and necessary expenses." (Sec. 38.) The statute did not specifically make a salary an allowable deduction, though it was so construed by the Bureau of Internal Revenue when the salary is a "reasonable and fair com-

[34] *Income Tax Procedure,* 1921, page 678 *et seq.*

[35] *U. S. v. Philadelphia Knitting Mills Co.,* U. S. Dist. Ct., Eastern Dist. of Penna., No. 4832, November 5, 1920, 268 Fed. 270. This case was under the 1909 law.

[36] 273 Fed. 657.

pensation for services rendered regardless of the amount of stock such officer may hold." We are asked to approve this executive construction of the statute as though it were part of it. In order not to beg the question, we must look to the statute alone to find the power which the Government asserts.

Confining our inquiry to the statute, it appears that the basis on which a salary may be allowed as a valid deduction is that it was in fact an "ordinary and necessary expense (of the corporation) actually paid. . . . . in the maintenance and operation of its business." To be a necessary expense it must have been paid for services actually rendered. (*Jacobs & Davies, Inc. v. Anderson,* 228 Fed. 505, 506.) Whether services were rendered and whether also they were commensurate with the salary paid are matters of judgment and discretion reposed by general law in the board of directors of the corporation. As the board of directors is charged with the duty and clothed with the discretion of fixing the salaries of the corporation's officers, the Government had no right (until expressly granted by statute) to inquire into and determine whether the amounts thereof are proper, that is, whether they are too much or too little. But, while the amount of salary fixed by a board of directors is presumptively valid, it is not conclusively so, because the Government may inquire whether the amount paid is salary or something else. Admittedly the Government has a right to collect taxes on net income of a corporation based on profits after all ordinary and necessary expenses, including salaries, are paid. It has a right, therefore, to attack the action of a board of directors and show by evidence, not that a given salary is too much, but that, in the circumstances, the whole or some part of it is not salary at all but is profits diverted to a stockholding officer under the guise of salary and as such is subject to taxation.

Of the same opinion was the learned trial judge, though in entering judgment of nonsuit he raised and ruled upon a second question which was not whether the salaries paid were commensurate with the services rendered but whether there was evidence which would sustain a finding that the sums paid were not all salaries but were part profits.

An inquiry of this kind is directed to a fact; and, as in all cases turning on a fact, the attention of the trial judge is directed to the sufficiency of the evidence to establish the fact. The question of fact here was whether the money paid was all salary or part profits. The presumption arising from the action of the board of directors was that it was all salary. In order to overcome this presumption the burden was on the Government to produce evidence, not necessarily conclusive, but sufficient to raise a valid inference that some definite part of the compensation was not salary but was profits.

Whatever peculiar features there may have been in the case, the court found no difficulty in enunciating the essential principle which must govern the Treasury's procedure.

"The presumption arising from the action of the board of directors was that it was all salary. In order to overcome this presumption the burden was on the Government to produce evidence, not necessarily conclusive, but sufficient to raise a valid inference that some definite part of the compensation was not salary but was profits."

A clearer statement is impossible. Salaries voted by the board of directors stand unless the Treasury can produce *evidence* that part of the payment was not salary but was in reality profits.

The arbitrary disallowance by revenue agents is not evidence, nor does it "raise a valid inference" that part of the payment is not salary. The burden is on the Treasury, not on the taxpayer, to prove its contention.

In spite of the clear and definite language used by the court, the following ruling appeared in Bulletin 39-21:

> RULING. In the ordinary case where an assessment is involved, if the Commissioner finds that a portion of an amount paid as salary or compensation is not properly compensation for services, and a taxpayer attempts to upset such finding, the burden of proof in court would be upon him (the taxpayer), to show that the action of the Commissioner was wrong and that such salary was nothing more than a reasonable allowance for compensation.
>
> It therefore clearly appears that the Commissioner is fully authorized to disallow a deduction as ordinary and necessary expenses of the full amount of an alleged salary paid to an officer by a corporation where the facts of the particular case show that the amount represents something other than compensation for services, and in order to determine this fact he (the Commissioner) may take into consideration salaries paid to similar officers of other corporations. . . . . (B. 39-21-1841; A. R. M. 138.)

The burden of proof is *not* on the taxpayer, but on the Treasury. If it can be shown that part of the payment represents something other than salary, the Treasury can disallow such amount, but only if evidence is forthcoming to that effect.

The Treasury is not authorized to use a stereotyped table of salaries to determine "reasonableness." What similar officers receive from other corporations is not relevant. The criterion is, "Is the payment a true salary?"

The Treasury contends that the decision applies only to 1917 and prior laws, and that the phrase, "including a reasonable allowance for salaries," which first appeared in the 1918 law, granted new powers to the Commissioner. This is not the case. The Commissioner claimed full powers prior to 1918.

In view of the statement of the court that Congress may limit the deduction for salaries, the question to be answered under the 1918 act is: Did Congress intend to delegate such a power to the Commissioner?

Assuming that Congress did intend to delegate such a power to the Commissioner (which is seriously doubted in the opinion of the author—the intention was to extend the deduction, not to extend the power of the Commissioner), it is doubted if Congress may delegate this power to the Commissioner. If this discretion may be delegated to him, why can not Congress go a little further and say that corporations and individuals shall pay a tax on a net income which shall be determined by the Commissioner of Internal Revenue?

It would be extremely difficult for Congress to place a limit upon officers' salaries other than the present limitation on deductions of "necessary expenses." In other words, a law would have to be framed so that all taxpayers would be treated alike and the fixing of a specific amount would be ridiculous. It would, moreover, be economically unsound to enact such a limitation.

The limitation to "necessary" is sufficient to prevent fraud. Any other limitation would impair the efficiency of honest concerns, and it would work many inequities. The operation of a corporation should be left in the hands of the directors. The author is of the opinion that there is no necessity for such a provision, because if salaries are arranged so as

to distribute profits, the Commissioner has ample power to require an adjustment.[37]

Amounts ostensibly paid as compensation—Test of deductibility.—

REGULATION. Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few stockholders, practically all of whom draw salaries. If in such a case the salaries are based upon or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries, if in excess of those ordinarily paid for similar services, are not paid wholly for services rendered, but in part as a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general

[37] *U. S. v. Philadelphia Knitting Mills Co.*, 273 Fed. 657.

just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. But if the salaries paid bear a close relationship to stock ownership, see paragraph (1) of this article. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[38] . . . . (Art. 105.)

In dealing with necessary expenses no possible fault can be found with the test laid down in the foregoing regulations regarding such payments, viz., whether they are reasonable or not.

The test of deductibility of compensation payments is whether or not they are legal and are in fact payments purely for services. When a salary is a necessary business expense it may be ten times as much as the Commissioner thinks a "reasonable" salary would be, yet the entire amount is an allowable deduction.

It must always be borne in mind that if the payments are allowed as expenses the recipients must report the amounts received as income. This is of special importance in dealing with employees whose compensation depends on profits.[39]

The Treasury is now considering the propriety of salaries claimed in returns for prior years, and many adjustments are being made. Too much weight is being given to comparisons with prior years. The 1917 and 1918 laws endeavored to reduce the inevitable burdens of the excess profits tax by permitting as deductions reasonable salaries, even though no salaries or very small salaries had been claimed in prior tax returns. Based on the higher cost of living and the higher salaries paid by business concerns whose officers are not large stockholders, it would seem that in some cases the allowances now being made by the Treasury are too low. The matter is one which must be settled on the merits of each case.

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[38] See Art. 32.
[39] See Chapter XIV.

Compensation fixed by contracts.—

Ruling. The committee has reached the conclusion that where salaries have been fixed long before any Excess Profits Tax Law was contemplated the Income Tax Unit is not authorized by the law or regulations to arbitrarily fix the salaries of the officers of any company at an amount less than that authorized. In general, the committee does not think that the Unit is authorized by law or regulation to look back of any corporate action fixing the salaries of officers when such action was taken by the directors long before any Excess Profits Tax Law was even contemplated, and where the salaries were not fixed on the basis of stock ownership or do not bear a close relationship thereto. Neither, in the judgment of the committee, is the Unit authorized to look back of any corporate resolution fixing salaries after the passage of the Excess Profits Tax Law, provided there is no evidence of intent to reduce the tax of the corporation, and provided that after deducting the amount actually fixed and paid the corporation has a normal return on its invested capital left, or where such deduction does not reduce the net earnings subject to tax below that of competing concerns which secure the services of officers and employees by open bargaining. (C. B. 2, page 110; A. R. R. 53.)

After the issuance of this ruling, the Treasury officials, in certain cases, reduced salaries, and in consequence a protest was filed by the taxpayers concerned, claiming that A. R. R. 53 (above) prohibits such action. The matter was again referred to the Committee on Appeals and Review, with the result that a memorandum of a more definite character answering specific questions was issued. This memorandum is digested as follows:

Ruling. Held, that compensation on whatever basis fixed representing only the price paid for services pursuant to a free bargain between a stockholder and the business enterprise is deductible in determining the taxable net income of such enterprise; that the Income Tax Unit has authority under the law and regulations to analyze the payments made as compensation for services rendered in order to determine whether there are included therein amounts ostensibly paid as compensation but which in fact represent a distribution of profits; and that A. R. R. 53 (C. B. 2, p. 110), is not applicable in cases where the element of free bargaining does not enter into the action taken by the board of directors of the corporation in fixing the amount of salaries to be paid to the officers who are controlling stockholders or sole stockholders, and particularly does not apply where the corporation

is owned, controlled, officered, and directed by the same persons. (B. Digest 39-21-1841; A. R. M. 138.)

The following quotation, which appears as an opinion of the Solicitor, is of interest here:

Ruling. . . . . It may be admitted that the expenses claimed as a deduction in any case were necessary in the sense of being legally binding and were incurred under a contract entered into in the best of faith and with no possibile reference to taxation, and yet if they were not "ordinary and necessary," if they were unusual and not essential to the maintenance and operation of the business and the properties of the corporation they would still be not deductible. Although they would admittedly be expenses they would not be the expenses for the deduction of which the statute provides. . . . (C. B. 3, page 133; L. O. 1045.)

The author reiterates his opinion that the Treasury cannot substitute its judgment for that of directors and stockholders.

Ruling. The salesmen employed by a corporation have contracts with it guaranteeing them weekly or monthly drawing accounts. Under these contracts the corporation is obligated to make weekly or monthly allowances so long as the salesmen remain in the employ of the corporation, regardless of the amount of business secured by them. It does not appear that any of the advances are repaid by the salesmen unless they earn commissions in a subsequent year in excess of such advances.

Held, that advances so made by the corporation in 1917, constituted an allowable deduction as a business expense in computing the corporation's net income for that year. (C. B. 4, page 117; A. R. R. 374.)

The case has arisen wherein a salary contract having a few years to run is terminated by the payment of a lump sum in lieu of stipulated annual amounts. Does such lump sum constitute a deduction in the year paid, or should it be prorated over the remaining years of the contract?

When the recipient reports the entire amount in the year received, it appears that such amount should be taken as a deduction in one year by the payer. While the inclusion of the total amount tends to make the salary accounts comparatively large, the termination of the contract may be to the best interests of the payer and therefore be considered necessary and reasonable in carrying on business in that year.

Factors which enter into the determination of the reasonableness of compensation.—

Ruling. The problem of determining reasonable compensation for personal services is one of difficulty, in that there are few general rules which can be laid down as guides to a decision. Many factors are involved, among them being the character and amount of responsibility, ease or difficulty of the work itself, time required, working conditions, future prospects, living conditions of the locality, individual ability, technical training, profitableness to the employer of the services rendered, and the number of available persons capable of performing the duties of the position. These and other factors have a bearing, and the amount of weight to be attached to each one can be determined only in the light of the circumstances in each particular case. (C. B. 1, page 220; T. B. M. 44.)

Method of determining reasonableness of compensation.—

Ruling. . . . . The department is not warranted in fixing any amount as a maximum limit for deductions for officers' salaries and compensation for personal services, but that each case must be decided in the light of all its circumstances. (C. B. 1, page 105; T. B. R. 46.)

The Committee on Appeals and Review has evidently deviated from this principle. For instance, in a later case the following appears:

Ruling. . . . . The application of the formulae provided by the compilation of salary statistics shows that the allowance for compensation made by the Unit is fully equal to the average of that paid for similar services by similar enterprises under similar circumstances, and though the computation of the amount appears to have been somewhat meticulous, the Committee finds no reason for any substantial modification. (C. B. 3, page 140; A. R. R. 223.)

Cases wherein compensation paid was held reasonable.—

Rulings. All the stock of a corporation was owned by its four officers, who devoted all their time and attention to the business of the corporation, acting not only as officers but also as buyers, bookkeepers, etc. These officers drew only nominal salaries of $1/36\ x$ dollars each for a number of years after organization.

The gross sales increased from $11\ x$ dollars in the first year of business to $64\ x$ dollars in 1916 and $90\ x$ dollars in 1917. Early in 1917, before the passage of any excess-profits tax law, the board of directors fixed salaries of $2\ x$ dollars each for three of its officers and

x dollars for the fourth. These salaries were paid in 1917 and deducted from gross income.

Held that the amounts paid and deducted were reasonable and properly deductible from gross income. (C. B. 2, page 109; A. R. M. 30.)

A company's gross sales in 1917 amounted to 1000 x dollars and its net income was 125 x dollars. Salaries and contingent compensation were paid to its officers and certain employees as follows:

	Basic salary.	Total.
President and treasurer	9 x dollars.	9 x dollars.
Secretary and general manager	6 x dollars.	18 x dollars.
Assistant treasurer	3 x dollars.	11 x dollars.
Office manager	x dollars.	9 x dollars.
Office manager (Y office)	2 x dollars	10 x dollars.
		57 x dollars.

Contracts were made prior to 1917 with these officers and employees for services to be performed. The value of the services to be performed and the possibility of securing more remunerative employment were taken into consideration in making the contracts. No payments were based on stock holdings. The contingent compensation or commission was paid for the purpose of retaining the services of men who had grown up with the business and were familiar with the various phases of the business, and was based on net profits after regular dividends had been paid.

The committee recommends that the full amount of compensation paid be allowed as a deduction, since it represented the price paid for services pursuant to a free bargain made in advance between the individual and the business enterprise. (C. B. 2, page 109; A. R. R. 31.)

A started a business a number of years ago with a small amount of capital. At a later date, the business was incorporated, 90 per cent of the stock being issued to A. The business was developed by his efforts until in 1917 the gross sales amounted to 555 x dollars and the net income to 65 x dollars, whereas in 1911 the gross sales amounted to only 167 x dollars and the net income to 8 x dollars. In prior years A, as president of the corporation, drew a nominal salary of x dollars, taking his earnings as dividends, but in 1917 his salary was increased to 10 x dollars.

In view of the extraordinary circumstances of the case, including the fact that A is and has been the sole administrative officer of the corporation and devotes his entire time to its direction in all details, the salary of 10 x dollars does not appear to be excessive and is, therefore, an allowable deduction as a business expense. (C. B. 2, page 109; A. R. R. 32.)

A, the president and treasurer of a close corporation, and B, its vice president, each held 45 per cent of the outstanding capital stock. C, its secretary, held 3 2/3 per cent of the stock. Nominal salaries were paid to A and C. There was an agreement between A and B that A was to receive in addition to his share on his capital invested, direct compensation in proportion to the results he might achieve for the company. Accordingly A, and C also, received in 1915, 1916 and 1917 as additional compensation 10 per cent and 1 per cent, respectively, of the profits. These amounts, although large, were not in proportion to stock holdings and having been paid according to agreement made in advance and for services rendered are held to be deductible as ordinary and necessary business expenses of the company. (C. B. 2, page 110; A. R. M. 39.)

Cases wherein compensation was held unreasonable.—

RULINGS. The Committee is of opinion that where a division of the profits of a business, as a bonus to its officers and managers, absorbs all the profits derived, except an amount sufficient to pay dividends at a moderate rate upon its preferred and common capital stock, such a distribution can not be regarded as an "ordinary and necessary" expense of business, and that the excess over a reasonable amount for compensation should be disallowed.

Such a distribution to managers and officers of a company which varied from year to year as to the percentage paid to each and where the same persons did not always participate in the distribution can not be said to have occurred as a result of open bargaining, or as the result of bona fide contracts and arrangements entered into and followed prior to the year 1917, even though such payments were, in fact, purely for services and in accordance with an established custom of the company. (C. B. 3, page 140; A. R. R. 223.)

A close corporation operated for a number of years prior to 1917, sometimes making moderate losses and sometimes moderate profits, paying only nominal salaries to its officers. In 1917 it was highly successful and distributed to the five stockholders who are also officers approximately 12 per cent of its net income, in exact proportion to their stock holdings. Of the total amount distributed 18 per cent was paid currently during the year and 82 per cent was paid on or about the close of the year 1917. In view of the salaries paid by other companies in the same line, doing a corresponding volume of business, the aggregate salaries paid appears to be excessive; and as some of the officers receiving the largest salaries did not devote all of their time to the work, a substantial part of the so-called salaries would seem to be nothing more than a distribution of profits. Forty per cent of the deduction taken for above salaries was not allowed. (C. B. 1, page 105; T. B. M. 70.)

Treatment of excessive compensation.—

REGULATION. As to the treatment of amounts ostensibly paid as compensation, but not allowed to be deducted as such, the following rules apply:

(1) In the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, the amount of the excess should be treated as dividends and would thus be exempt from the normal tax in the hands of the recipients. If such payments constitute in part payment for property, the amount of the excess should be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price.

(2) In the case of excessive payments by individuals or partnerships, the amounts disallowed should ordinarily be treated as shares of the profits of a partnership, except that a payment for property should be treated by the individual or partnership as a capital expenditure and by the recipient as part of the purchase price.[40] (Art. 106.)

The foregoing regulations are properly applicable whenever distributions of profits ostensibly as compensation have been made. The 1922 regulations omit part of the same article in Regulations 45, which attempted, in effect, to treat excessive payments as salaries in order to deny to the recipients the right to credit the normal tax.

RULING. The Unit reduced the amount of the deduction claimed by the M Company for salaries of its officers which had been voted by its board of directors. It is stated by one of the officers that such action would necessitate the return to the corporation of the amount disallowed as a deduction for salaries, and a request is made for permission to file an amended return for the years the excess salaries were paid to him and that the overpayment on his returns be credited to the payment of tax for 1920.

Held, that where a corporation by proper action of its board of directors votes compensation to its officers, and the corporation has paid the amount to them, the individuals must report the full amount of such compensation in their individual returns. The amount disallowed as a deduction by this office on account of excessive salaries paid by a corporation has no effect on the legality of the corporation

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[40] [**Former Procedure**] T. D. 2696, April 10, 1918, which covered most of the points contained in articles 105 (see page 876) and 106, above quoted, also provided:

"If a compensation contract with the majority stockholder or stockholders is approved by all the stockholders, as well as by the directors, it might, however, be dealt with like any other contract."

act in actually paying the excessive compensation to its officers. An individual to whom an amount of salary has been paid by a corporation in excess of the amount allowed the corporation as a deduction for compensation paid its officers is under no obligation to refund the excessive amount of salary to the corporation. The individual should report as income the entire amount of salary paid by the corporation for the year in which received or accrued.

It is held further, that under article 106, Regulations 45, the excess of the amount allowed the corporation as a deduction in returns of annual net income and which bore a close relationship to the stock holdings of such officers are not subject to normal tax in the hands of the recipients. No claim for refund will lie if the payments made ostensibly as salaries represented an appropriation of assets of the corporation. (B. 35-21-1792; O. D. 1012.)

The foregoing is in some respects contradictory and is based on article 106 before it was modified in the 1922 regulations. If the salaries were in fact excessive, they were illegally voted by the directors. If, upon full investigation, it was found that profits were being distributed, it was proper to disallow the deductions for expenses; but if the payments were not in exact proportion to stockholdings, the directors acted illegally and the excess payments should be returned.

Bonuses and other special compensation[41]—Although the question of bonuses is covered in a general fashion in articles 105 and 106 of the regulations, quoted above, it is more specifically treated in the following paragraph:

REGULATION. Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. . . . . (Art. 107.)

This regulation accords with sound business practice.

[41] [British Practice] "The principle established would extend to bonuses as follows: where the payments are made to the employees because they are employees they are assessable. They are in every way regarded as part of the salary earned. The employer may, of course, include them among his expenses for purposes of his own assessment." *Income Tax Practice*, by W. E. Snelling (London), 2nd Ed., page 126.

However, it has not been observed by all revenue agents. If a taxpayer believes that deductible items have been disallowed an appeal should be made to the Commissioner, who can be depended upon to confirm the regulation just quoted.

The question of reasonableness is one which must be left, in most cases, to the directors of a corporation. A bonus may appear to be unreasonable, but if paid in good faith it becomes a necessary business expense.

It would be a fine thing if the Treasury could disallow all overpayments to employees, and distribute the aggregate to underpaid employees. Unfortunately there are obstacles to such procedure.

In the opinion of the author the courts will not disallow any compensation, no matter how unreasonable it appears to be on the surface, and no matter how large it seems to be when compared with the amounts paid by other concerns, unless the payment is proved to be merely a division of profits distributed proportionately to stockholdings.

Contingent salaries are deductible in the year paid.—

Ruling. When additional compensation is agreed to be paid by a corporation to its officers at a future date, upon the happening of certain contingencies expected to result from the rendition of services, the amount of such compensation being left for future determination, the amount eventually so paid is not to be treated as back salary and allocated to the years during which the services were rendered, but constitutes a business expense to the corporation for the taxable year in which the same was paid. (C. B. 3, page 142; A. R. R. 232.)

Salaries may be determined after close of fiscal year—when?—

Ruling. The compensation of the officers of a corporation had been continued without change for several years. In 1919, two days before the close of its fiscal year, the salaries of the principal officers of the corporation were largely increased for the year then closing.

Section 234 (a) of the Act of 1918 provides that in computing the net income of a corporation subject to tax there shall be allowed as deductions all ordinary and necessary expenses paid or incurred

during the taxable year, including a reasonable allowance for salaries. The authorization to increase the salaries in question occurred before the books were closed for the fiscal year, and as such became a liability of the corporation for that year. If the compensation thus authorized was reasonable the total amount is an allowable deduction. (C. B. 2, page 111; O. D. 504.)

The foregoing case should be distinguished from cases like the following:

Ruling. The M Company, years ago, established an annual bonus system for paying its officers and employees additional compensation for services rendered. In 1914, 1915 and 1916 no bonuses were paid, and on January 1, 1917, the system was abolished. The bonuses as to amount were always fixed by an officer who resided in Europe, and who usually visited this country once a year. War conditions in 1917 and 1918 prevented his visiting this country, and consequently the amount of the bonuses was not determined until his visit in 1919, at which time bonuses were paid for 1916.

Held, that the bonuses in question were not paid on account of services rendered during the year 1919, and therefore can not be deducted as items of business expense for that year. Bonuses or additions to salaries voted subsequent to the close of any taxable year, and also subsequent to the closing of the books for such taxable year can not be considered as ordinary and necessary expenses of doing business during such year as are deductible under the Revenue Act of 1918.

The aggregate of these bonuses constitutes income to the recipients for the year 1919 because they were first credited to them and made available during that year. (C. B. 2, page 111; O. D. 497.)

In other words, the business could deduct the expense in 1916 (a low tax year) if at all, but the recipients were taxable in 1919 (a high tax year)! In view of the specific reason for the delay, which rendered an election by the employees impossible, the latter should have been permitted to file amended returns for 1916.

Ruling. The Committee recommends the disallowance of additional compensation claimed by a corporation as a deduction for 1917 where such additional compensation was not as a matter of fact authorized or paid until 1919 and that such additional compensation be allowed as a deduction under the heading of ordinary and necessary expenses in the taxpayer's return for the year 1919 in which year the payment was actually made. (C. B. 4, page 134; A. R. R. 519.)

In this case, the secretary-treasurer of a corporation performed all of the executive duties of the president during the latter's illness in 1917, but due to a combination of circumstances it was not possible to pass the appropriate additional compensation resolution until 1919.

Under proper accounting methods the profit of 1917 should bear the expenses of the services performed in that year, even if payment was not made until two years later. For this reason, the deduction in 1917 should have been permitted.

The Committee quoted T. B. M. 86[42] in its opinion as follows:

> RULING. . . . . Salaries voted subsequent to the close of any taxable year, and also subsequent to the close of the books for such taxable year, can not be considered an ordinary and necessary expense of doing business. . . . .

The ruling is sound or unsound depending on circumstances. The date of voting a salary is not of major importance. An officer or employee who renders service is entitled to reasonable compensation from day to day (even though none is voted), under the ordinary rule of law that the recipient of a benefit is bound to pay for it unless there is a prompt disavowal of an intention to pay.

"Christmas gifts."—Regulations 62[43] do not specifically discuss the deductibility of the "Christmas gifts" which so many business houses are accustomed to distribute to employees each year. The reasoning of article 105 would indicate that such payments to employees are deductible so long as the total compensation, including such payments, "is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances." However, it may be that the Treasury expects to classify these payments in the category of "donations" as defined in the following paragraph.

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[42] C. B. 1, page 106.
[43] See page 420.

REGULATION. . . . . Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income. (Art. 107.)

In the author's opinion the Treasury, in the matter of Christmas gifts and similar items, has not always interpreted the law properly in the past. Most Christmas gifts to employees are wages, pure and simple. Particularly where the gifts are large, an employee, on being asked the amount of his compensation for the year, will in his answer name a figure which includes the "gifts." This is not a theory. It is standard business practice to include items of this kind as one of the necessary business expenses intended by the framers of the law to be an allowable deduction.

Educational and "welfare" outlays for employees.—It is now considered advantageous for an employer to educate and stimulate his employees in all matters relative to the business and to promote their development so that they may become more useful and valuable. Schools are founded, classes are formed, lecture courses are arranged, gymnasiums are opened, athletic games are encouraged, entertainments are provided, and many other ways are found of carrying out the purpose in view. Some of these plans appear to be altruistic and of a semi-charitable nature. When this idea is uppermost, the cost of the ventures should be entered on the books as gifts or donations.

If, as is often the case, the controlling motive is the betterment of the business, the cost is a business expense, pure and simple, even though the results are disappointing. In these days of labor and other administrative troubles, the cost of any practical and effective plan of improving the moral, mental and physical condition of employees is a practical business expenditure. It is not a charitable scheme. It is a money-making, not a money-spending, proposition. In the opinion

of the author such expenses are allowable deductions and may be so claimed.

RULING. Inquiry is made whether the following are allowable deductions in the income tax returns of a taxpayer:

(1) Amounts expended in outfitting a baseball team which represents the taxpayer, and the uniforms of which bear the name of the taxpayer the players represent.

(2) Expenses incurred in furnishing entertainment to the taxpayer's employees by means of picnics or dances.

Inasmuch as it appears that the name of the taxpayer is given considerable publicity in the appearance of the taxpayer's baseball team in various parts of the district in which the taxpayer does business and by a report of the games in the newspapers of the vicinity, it is held that the expenses incurred relative to the outfitting and support of the ball team representing the taxpayer are similar to those expended in other methods of advertising and are deductible as business expenses in the income tax returns of the taxpayer.

However, expenses incident to the furnishing of entertainment to the employees by means of picnics or dances are not such "ordinary and necessary" business expenses as are comprehended by the Revenue Act of 1918, and therefore are not allowable deductions from gross income for purposes of computing income tax. (B. 37-21-1815; O. D. 1030.)

The author is of the opinion that the latter part of the foregoing ruling is unsound.

Such entertainments contribute to a finer *esprit de corps*, which in turn is reflected in the productivity of the business. If the directors believe that the expenses are necessary, the burden of proof is on the Treasury to show that they are not.

RULING. Where a corporation encourages or requires its employees to attend part-time schools it may deduct as a business expense reasonable amounts paid as compensation to such employees during their absence from employment while attending such schools. (C. B. 4, page 130; O. D. 850.)

Pensions to ex-employees and their dependents.—

REGULATION. Amounts paid for pensions to retired employees or to their families or others dependent upon them, or on account of injuries received by employees, and lump-sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. No deduction shall be made

for contributions to a pension fund held by the corporation, the amount deductible in such case being the amount actually paid to the employee. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted. . . . . (Art. 108.)

This regulation recognizes that the total payments to employees themselves or to their dependents are allowable deductions.[44] It is open to criticism, however, because of its refusal to permit the deduction of amounts set aside during accounting periods as accruing expenses. The regulation is inconsistent with other regulations which permit deductions for liabilities incurred but not paid. Amounts appropriated to pension funds are supposed to approximate the liabilities which attach to all pension plans. Obviously in many cases actual payments are deferred, but if it can be shown that the contributions to a fund are not in excess of the reasonable requirements of the pension plan, applicable to the employees on the payrolls during the period in question, the entire contribution is clearly a necessary expense of the business.

Contributions to pension funds which are deductible.—

Ruling. Donations by a corporation to a pension fund for the benefit of its officers and employees, the fund being organized entirely

[44] [Former Procedure] The procedure in regard to the deductibility of pensions paid to dependents of employees has had a checkered history. T. D. 2090 provided that:

Regulation. Amounts paid for pensions to retired empolyees, or to their families, or others dependent upon them, or on account of injuries received by employees, are proper deductions as ordinary and necessary expenses.

However, the 1918 edition of Regulations 33, articles 136 and 137, took the position that:

Regulation. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, no services being rendered by the widow or heirs, such payment is not "ordinary and necessary" expense of transacting business and does not constitute an allowable deduction.

This was once more reversed by Reg. 45, Art. 108. Art. 108 of Reg. 62 is the same as in Reg. 45.

separate and distinct from the corporation, having its own set of books, making its own investments, and paying its own expenses, legal title of which does not remain in the corporation, are deemed to be donations to a charitable institution conducted for the benefit of the corporation's employees or their dependents representing a consideration for a benefit flowing directly to the corporation as an incident of its business and are allowable deductions from gross income in determining net income subject to tax. (C. B. 1, page 224; O. D. 110.)

Commissions of various types.—

COMMISSIONS PAID TO SALESMEN AND COMMISSIONS ON INSURANCE PREMIUMS DEDUCTIBLE.—

REGULATION. . . . . Commissions paid salesmen, ... commissions on insurance premiums, ... are income to the recipients; . . . . (Art. 32.)

Consequently they are deductible as compensation for services.[45]

MANAGEMENT COMPENSATION OR COMMISSIONS PAID AGENTS DEDUCTIBLE.—An old Treasury decision specifically states that:

RULING. A commission paid to a real estate agent for collecting rents and for management of property, is a legitimate business expense and constitutes an allowable deduction in computing net income. (T. D. 2090.)

The same rule would apply to the charges of trust companies or other agents who collect income and manage personal as well as real property.

Usually the recipient of the income receives and enters a net amount and fails to record the items of gross income and deductions therefrom. Where part of the income is from dividends or tax-free covenant bond interest this method results in a loss of the credits for normal tax. When all the items of income are entered gross there should also be entered as deductions the expenses which are applicable to the income.

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[45] See page 420.

Commissions paid to stockbrokers not deductible as expenses.—

Regulation. . . . . Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price. . . . . (Art. 293.)

When securities are sold the profit is decreased or the loss is increased by the commissions charged. Therefore the amounts paid in such commissions are fully deductible eventually.

Compensation paid in stock deductible.[46]—

Regulation. . . . . Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. . . . . (Art. 33.)

Stock issued to employees for services.—During recent years many concerns have sold stock to their employees so that they may participate in the profits of the business. Generally, these sales are made on an instalment plan, the company crediting a small amount each year to the employee, which is applied to the purchase of the stock. The employee also pays a small amount every week or month, which is likewise applied against the purchase price of the stock.

The amounts which the company credits to the employee are for services rendered and are deductible as a necessary business expense.

Rulings. A proportionate part of the par value of a company's stock delivered to a trustee to be held in escrow for the benefit of certain employees of the company which stock is to be delivered to them at the expiration of a number of years in recognition of faithful service, may be taken as a deduction in the income tax returns of the company for each of such years during the period the trustee holds the stock, providing the corporation keeps its books on an accrual basis.

If the employee for whom the stock was deposited should forfeit

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[46] See page 430.

his right to receive the stock, the corporation must report as income in the year in which the right to receive the stock is forfeited, the amounts taken as a deduction in previous years on account of the forfeited stock. (C. B. 1, page 107; O. D. 124.)

If a corporation distributes shares of its treasury stock to its employees as additional compensation, the market value of the stock at the time of distribution is deductible by the corporation. Any difference between such market value of the stock and its cost to the corporation is neither taxable gain nor a deductible loss to the corporation. (C. B. 4, page 137; A. R. M. 114.)

This ruling depends on the fact that no taxable profit or deductible loss can arise from transactions engaged in by a corporation in its own treasury stock. Had it distributed stock in some other corporation owned by it, the difference between cost and market price would be a taxable profit or deductible loss, as the case may be.

Compensation to employee of a partnership under a participation of profits agreement deductible.—

Regulation. . . . . compensation for services on the basis of a percentage of profits . . . . [is] income to the recipients; . . . . (Art. 32.)

It follows, of course, that the payment constitutes an item of business expense to the partnership.

Partners' and sole proprietors' so-called salaries.—Except for the purposes of excess profits taxation the designation of salaries for partners or proprietors is essentially an artificial and pointless practice. Withdrawals made by individuals or partners from a business in which they own all or part of the capital are normally in anticipation of profits. As between partners, salary allowances may serve to adjust or define distributions of profits or sharing of losses, but merely calling such drawings expenses does not make them so.

In the language of the Treasury:[47] "Wages or salary drawn by a taxpayer from his own business are more in the nature

[47] *Income Tax Primer*, 1918, question 62.

of a charge out of profits than a charge against profits. If such could be deducted they would merely be added to his income, the effect of which would be to take money out of one pocket and put it in another." For the proper determination of super-normal profits, however, it was necessary to take such deductions into account.

Insurance

Life insurance premiums paid by insured not deductible.—

REGULATION. . . . . Premiums paid for life insurance by the insured are not deductible. . . . . (Art. 291.)

RULING. Where a corporation insures the life of its president, the stockholders being beneficiaries in proportion to their stock holdings and the wife of the president (not herself a stockholder) being a beneficiary in proportion to her husband's stock holdings, no deduction for the payment of premiums can be allowed under article 294 of Regulations 45, as amended by T. D. 3019, since the corporation itself is indirectly a beneficiary under the policy.

The premiums paid on such a policy are a charge against surplus and represent dividends to the stockholders subject to surtax to the extent that such premiums are paid out of earnings or surplus accumulated since February 28, 1913. This applies as well to the officer upon whose life the insurance is carried. (C. B. 3, page 192; O. D. 659.)

As no part of the proceeds of the policy would be paid to the taxpayer the Treasury ignores the corporate entity in the foregoing decision. The decision is sound, however, from an equitable if not from a legal point of view. When the equity is in favor of the taxpayer the Treasury finds it impossible to look through the corporate entity.

Whether or not the deduction of life insurance premiums of this type should be permitted resolves itself very largely into a question as to whether or not the degree of security of a source of income shall be taken into account in levying a tax on the income from that source. For example, shall income from personal effort, which may suddenly be terminated at the death of the producer, be given some concession compared with "funded" income? In England, where this question is

of long standing,[48] the earned incomes are not only taxed at lower rates but premiums on insurance on one's own life or that of his wife are deductible up to one-sixth of the net income.[49]

At the time the 1913 law was passed Judge Hull explained that no deduction was permitted for such expenditures because the exemption was large enough to cover them. The exemption was materially lowered in the 1917 law, but no deduction was provided for life insurance premiums.

"Business" life insurance premiums not deductible.[50]—

LAW. Section 215. [Individuals and corporations—items not deductible] . . . . **(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.**

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[48] Seligman, *The Income Tax*, pages 79, 133, 154-155. After first permitting the deduction and then forbidding it, the permission was firmly established in the law in 1853.

[49] Murray and Carter, *A Guide to Income Tax Practice*, 8th Ed., page 259. The allowance, however, is "not admissible as a deduction in arriving at the total income for the purpose of a claim for relief in respect of 'earned income.'"

[50] [Former Procedure] Under T. D. 2090 (December 14, 1914) premiums on such insurance were deductible, but when the policies matured or upon the death of the insured the amount received was reportable as income. This procedure was changed by T. D. 2519 (August 30, 1917) which forbade the deduction of the premiums annually but provided instead that they might be cumulated and deducted from the gross proceeds, when received, of any policies of which the business concern was the beneficiary. As applied to term policies for special purposes if there was no surrender value, the premiums represented a business expense and credit should have been claimed therefor. The test of deductibility prior to 1917 should rest on reasonable protection to a business as against investment or profit possibilities. If the premiums paid merely provided for reimbursement of possible business losses by fire or death of a valuable executive, or against any true business risk, the cost of insurance was correspondingly a true business expense.

1917 LAW. Section 32. "That premiums paid on life insurance policies covering the lives of officers, employees or those financially interested in any trade or business conducted by an individual, partnership, corporation, joint-stock company or association, or insurance company, shall not

"Group" insurance premiums are deductible.—The law disallows deductions for premiums only when the taxpayer is a beneficiary. So-called "group" insurance premiums are deductible because the proceeds of the policies are paid to someone other than the taxpayer.

REGULATION. . . . . If, however, the taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. . . . .[51] (Art. 294.)

Accident insurance premiums.—The 1921 law,[52] and regulations[53] hold that proceeds of accident insurance policies are not taxable income. Therefore premiums paid for accident insurance are not allowable deductions. The controlling reason for taking out accident insurance is to secure special income in case one's regular income is shut off. It would therefore seem logical to tax the income and allow credit for premiums paid and for any unusual expenses arising from the contingency giving rise to the payment of the insurance.

In the case of a business, however, such premiums are deductible.

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be deducted in computing the net income of such individual, corporation, joint-stock company or association, or insurance company, or in computing the profits of such partnership for the purposes of subdivision (e) of section eight (3)."

A possible explanation of the insertion of Section 32 in the law in 1917 is the desire to prevent evasion. It is conceivable that in a year of high tax rates a concern might reduce its taxes by insuring heavily various persons associated with the business. Evasion would be particularly easy if the various types of "investment" insurance were available.

The provision of the 1918 law was inserted in the 1921 act without change.

[51] In an early edition of Regulations 45, this sentence read as follows:

"But if the taxpayer is in no sense a beneficiary under such a policy, except as he may derive advantage from the increased efficiency of the employee, and pays the premiums purely as reasonable additional compensation of such employee, they are allowable deductions."

[52] Section 213 (b-6).

[53] See page 351.

Property insurance premiums—when deductible.—

REGULATIONS. . . . . Other items that may be included as business expenses are . . . . insurance premiums against fire, storm, theft, accident or other similar losses in the case of a business. . . . . (Art. 101.)

Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense. . . . . (Art. 291.)

In conformity with these rulings, premiums on insurance covering a dwelling house occupied by the owner may not be deducted.[64] On the other hand, if the insurance covers a barn on a farm it is deductible.

Premium on fidelity bonds deductible.—

REGULATION. Where an employee is required to furnish bond and pay the premium on such bond as a necessary incident to his employment, the premium on the bond will constitute an allowable deduction in computing net income. (T. D. 2090.)

RULING. Premiums paid on indemnity bonds furnished by Government employees for the faithful performance of their duties constitute allowable deductions in computing net income for the purpose of the income tax. (C. B. 4, page 124; O. D. 878.)

If the premium is paid by the employer the payment is likewise deductible as a business expense.

Premiums paid on insurance policies to secure loans.—

RULINGS. A taxpayer who borrowed money for business purposes and was required to take out life insurance in favor of the lender as security for the loan, is entitled to deduct the premiums paid for such insurance as a business expense under Section 214 (a) 1 of the Revenue Act of 1918; however, the premiums will cease to constitute a business expense upon maturity and payment of the loan. (C. B. 2, page 104; O. D. 396.)

The premiums paid on a life insurance policy taken out by a taxpayer for the sole purpose of protecting a bank from which he procured a loan, constitute an allowable deduction in determining net income, even though the insurance was not taken out until some time after the loan had been made. (B. Digest 35-21-1791; O. D. 1011.)

Likewise it would appear that if any policy were assigned

[64] *Income Tax Primer,* 1918, question 67.

to secure a loan, the premiums would immediately become deductible, but the Treasury has held that:

RULING. Office Decision 396 (C. B. 2, page 104), holding that premiums paid on a life insurance policy required as collateral for a loan are deductible as a business expense, is to be strictly construed. The policy must have been taken out for the sole purpose of using it as security for the loan. A taxpayer is not permitted to deduct the premiums paid on a policy taken out prior to the negotiations for a loan and later assigned to the lender as security for such loan. The subsequent assignment of the policy to the lender is merely incidental to the purpose for which the policy was secured, and no additional expense is incurred or loss sustained by virtue of its temporary use as collateral. The increase in the cash surrender value of a policy accruing during the period it is used as collateral is not to be considered in computing the net income of the person who pays the premium.

A corporation which takes out a policy on the life of one of its officers for the purpose of using the policy as collateral may not deduct the premiums paid thereon. (C. B. 3, page 139; O. D. 711.)

It is difficult to reconcile the last paragraph of the foregoing ruling with O. D. 396. It is made plain, however, that in certain cases life insurance premiums are deductible even though the taxpayer is "indirectly" a beneficiary.

It would also appear that if a creditor takes an assignment of life insurance as security, he will be entitled to deduct the premiums paid on the insurance, if the debtor fails to pay the premiums.

When changes such as renewals and reduction of loans occur, it may be necessary to divide the amount paid as premiums in order to arrive at deductible portion.

RULING. In case a loan is renewed for the full amount, and a policy of insurance taken out in favor of the lender for the express purpose of securing the loan is continued as security, the premium paid thereon by an individual taxpayer is deductible as a business expense under the same conditions applicable in the case of the original loan.

If partial payment is made upon the maturity of the loan, and the loan is renewed for the reduced amount, the premium paid is deductible only to the extent that it is paid on insurance required as security for the reduced amount of the loan. (C. B. 4, page 123; O. D. 843.)

"Self-insurance" reserves.—

Regulation. Funds set aside by a corporation for insuring its own property are not a proper deduction, but if such funds are set aside, or a reserve therefor is set up, any loss actually sustained and charged to such funds or reserves may be deducted. (Reg. 33, 1918, Art. 144.)

If the amounts set aside are simply equal to the premiums charged by an insurance company it is quite possible that the courts would decide that such reserves or provisions against losses would be allowable deductions as business expenses. Certainly sound accounting practice requires that such items should be charged to an expense account.

Insurance under workmen's compensation laws.—Premiums paid to insurance companies or state insurance commissions by employers under workmen's compensation laws are deductible. If these laws permit an employer to establish reserves for the purpose of carrying the risk, such reserves cannot be deducted, but payments to employees from such reserves are deductible.

Rulings. Under the Workmen's Compensation Law of a State, employers are required either to make periodical payments to the State Insurance Fund created to compensate employees for injuries received in the course of their employment, or to maintain a benefit fund providing for the payment of such compensation, giving a bond as additional security for the payment of such compensation.

Where the employer makes the periodical payments to the insurance fund of a State such payments are allowable deductions for the year in which paid or accrued.

If, however, the employer maintains a fund actually depositing periodically in a trust company an amount to be held in reserve as a special fund for the payment of compensation as injuries occur, the amount thus deposited is not an allowable deduction from gross income, since there is no means of determining how much of this fund will be used for the purpose for which it is held. In such case the actual amount paid during a year to the employees as compensation where injuries occur is a proper deduction for that year whether the amount so paid is greater or less than the deposits made during the period to the fund which is maintained. (B. 27-21-1712; O .D. 964.)

A corporation carried its own compensation insurance in accordance with the Workmen's Compensation Law of the State of

Pennsylvania. Compensation for personal injury to, or for the death of, an employee by an accident in the course of his employment is based upon a certain percentage of the employee's wages, with certain stated maximum and minimum limitations, payable in periodical installments, the same as wages, over periods extending in some cases as long as 16 years. The compensation thus fixed is subject to change in the event of a subsequent change in the disability status of the employee, or his status as to dependents. The amount of compensation is fixed by the Compensation Board of the State. In some cases the board may order the compensation paid in a lump sum.

By filing a certified copy of the agreement or award with the Court of Common Pleas of any county in the State, the amount of compensation shown in such agreement or award will be entered as a judgment against the employer, which judgment is a lien against the property of the employer from the date of filing the agreement or award. Execution in all such cases shall be for the amount of compensation and interest thereon due and payable up to the date of the issuance of the execution, with costs, and further execution may issue from time to time as further compensation shall become due and payable until the full amount of the judgment with costs shall have actually been paid. (Sec. 428.)

Only so much of the award as under its terms the corporation was required to pay during the taxable year may be accrued as a liability for that year. (B. Digest 49-21-1959; O. D. 1123.)

Under the Ohio Workmen's Compensation Law certain employers are allowed to carry their own risk or insurance. Compensation payments in case of industrial injury are usually paid in weekly installments. In death and permanent disability cases the Ohio Industrial Commission makes an award covering the total liability in each case. The employer then sets aside a reserve covering the amount of the award and makes weekly payments until the entire award is exhausted.

The question submitted is whether the entire amount of the reserve set aside may be deducted in the year in which the award is determined and the reserve set aside or whether the amount of the reserve should be allocated to the years in which actually paid.

Held, that only so much of the award as under the terms of agreement the employer is required to pay during any year, represents a liability against profits for that year. The employer may therefore deduct in any year the amount of the award paid or accrued during that year. (B. 33-21-1768; O. D. 992.)

The foregoing ruling is not sound. Correct accounting procedure requires the setting up of a liability when it is ascertained. The entire award is a determined liability and should

therefore be allowed in full in year of award. It in no way benefits future operations, and payment in instalments is similar to discharging any liability in instalments. The method of payment does not determine the period in which the liability is deductible.

RULING. Where insurance is taken out by a corporation on the life of the guarantor of a debt to the corporation, the surrender value of the policy can not be included in invested capital but the premiums paid may be deducted as a business expense.

An amount received by the corporation in 1919 from the insurance company in distribution of a 20-year surplus should be included in gross income for that year.

The amount received upon the death of the insured in excess of the cash surrender value of the policy on March 1, 1913, must be accounted for as income of the year in which received. (B. Digest 47-21-1938; O. D. 1109.)

Insurance reserves to equalize profits not deductible.—

RULING. The present recommendation is made in response to a request that reserves for crop insurance be allowed as deductions from gross income.

The argument of the petitioners, briefly summarized, is as follows:

The canning industry is peculiarly subject to localized climatic conditions which greatly affect the output from year to year.

The expenses of a cannery being to a large extent constant, the result is that the cost per unit of output is much less in the year of large crops than in the years of crop failure.

The climatic conditions being local rather than general, the high cost per unit in the years of scant crops is not compensated by the higher prices of output: and there results an alternation of abnormally high profits and abnormally low profits, depending on the alternation of favorable and unfavorable climatic conditions.

On the theory that these changes follow a somewhat definite cycle, it is claimed that an equitable adjustment would be secured by establishing a reserve for crop insurance as suggested above.

The Revenue Act recognizes that in any business the profits may vary from year to year. It deliberately adopts the policy of levying additional taxes on annual profits above the average. It does not make any corresponding reduction for a year in which the profits are below the average. An actual net loss in one year may, under section 204, be offset against net profits of another year, but this is a special relief provision limited in its application to the narrow class of cases covered by that section. The equalization of profits between

years which show no loss or the accumulation of reserves against future losses are not sanctioned by the law. In general, the statute evidences a clear intent to restrict within the narrowest limits deductions for addition to reserves other than the reserves of insurance companies required by law. It is doubtful even whether a reserve against an incurred but unpaid liability can be recognized, when the liability is at all indefinite. But there can be little doubt that a reserve against a future loss is unrecognized by the statute, and no doubt at all that a reserve against fluctuations in future profits has no standing of a kind which would warrant the deduction of additions thereto in computing net income for purposes of taxation.

The allowance of a charge for crop insurance clearly differs from the allowance for depreciation in the element of definiteness of calculation. The certainty of depreciation is unquestioned, and the life of the depreciating asset can be estimated with a fair approximation of accuracy. But even the depreciation allowance is given by virtue of express statutory authority.

The theory of a regularly recurring crop cycle, particularly as limited to localized industries, is still a theory. The particular theory of a crop cycle cited in the petitioners' brief refers to a general worldwide cycle. Such a cycle is deliberately ruled out of consideration by the petitioners who claim that while a general shortage of crops would in part be compensated by higher prices, the shortages for which they wish to provide are local shortages in closely contiguous territory which are so limited as to have no noticeable effect on general market prices.

The petitioners claim that if a crop insurance reserve is capable of being determined with reasonable certainty, it is an allowance the canner has a legal right to claim but admit also that crop insurance has entering in it so many variable factors that no insurance companies will write the risks. The petition therefore in part rests on a debated economic theory which relates at best to conditions not applicable to the case at issue, and in part on an admittedly non-existing accuracy of calculation.

The request is in effect a proposal to equalize profits in a manner not contemplated by the Act, and it is accordingly recommended that the petition be denied. (C. B. 1, page 103; T. B. R. 13.)

The author is of the opinion that the foregoing ruling is in accordance with the law. He is also of the opinion that the argument of the canning industry is economically sound, and that a change should be made in the law to meet these conditions.

The Treasury has held[65] that if insurance has actually

[65] C. B. 1, page 104; O. D. 215.

been taken out, the premiums are deductible as necessary business expenses. This perhaps is a way out of the difficulty, as it should be possible for each industry to organize an insurance company.

The 1921 law[56] grants the relief sought, at least in part. Losses of one year may be carried forward one or two years.

Procedure when premiums are paid in advance.—

Regulation. Premiums paid in advance, covering a period of several years, are to be taken as a deduction on the basis of one of two methods. When the books are kept on a cash basis, the entire amount is deductible in the year in which the premium is paid. When the books are kept on an accrual basis the premium is to be prorated over the period covered by the insurance. (Reg. 33, 1918, Art. 8.)

Assessments for insuring bank deposits.—

Regulation. Banking corporations, which pursuant to the laws of the States in which they are doing business, are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund, provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers. (Art. 567.)

Rentals

No difficulty arises concerning ordinary rentals paid in cash in business operations. Sometimes, however, the rental charge is increased by expenditures not included in the cash

[56] Section 204.

payments to the landlord. These, of course, are deductible under the head of rentals.

Rentals paid to stockholders of a corporation based upon net profits are held not to be dividends if payments were made for use of property and were not based on stockholdings.[57] Ostensible rental payments which are in reality distributions of profits to stockholders will not be allowed by the Treasury as business deductions.

Certain interest payments are held to be the equivalent of rentals and are deductible as such. (See page 931.)

Taxes paid by a tenant.—

REGULATION. . . . . Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. . . . . (Art. 109.)

A statement in the *Primer* emphasizes the fact that in this case the property must not be used by the tenant as a home.[58]

Permanent improvements on leased ground.—

REGULATION. . . . . The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation.[59] (Art. 109.)

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[57] *In re General Film Corporation*, 274 Fed. 903.

[58] *Income Tax Primer*, 1918, question 69.

[59] [Former Procedure] In an early edition of Regulations 45, this part of this article read as follows:

"The lessee will not be permitted to deduct from the gross income any depreciation with respect to such buildings, but the cost of incidental repairs necessary to keep them in an efficient condition for the purposes of their use may be deducted. If, however, the life of the improvement is less than the life of the lease, depreciation may be taken by the lessee instead of treating the cost as rent."

The Treasury has held, however, that a reserve to cover a possible but unknown cost of restoring the premises to their original condition is not deductible. The cost of restoring the property at the expiration of the lease, if the lessee is required to restore it, will be an allowable deduction for the year in which it is actually incurred.[60]

Rental of apartment deductible when subleased.—

RULING. . . . . The taxpayer lived in an apartment where it was the custom of the residents to sublease their apartments or houses for the summer months. In his 1920 return the taxpayer included in his gross income the amount received as rent for the apartment which he sublet and deducted as a business expense the amount which he had to pay as rent for the apartment, claiming that he had sublet his apartment as a purely business proposition and that the transaction was entered into for profit. He occupied no part of the apartment after it was sublet.

Held, that the rent which the taxpayer was required to pay for the apartment during the time that it was sublet at a profit is deductible in computing net income. (B. 50-21-1972; O. D. 1134.)

Deduction for payment for cancellation of lease.—Although the following case does not come under the principle upon which article 109 is based, it was decided in accordance therewith:

RULING. A business property was leased for a term of years, but prior to the termination of the lease the lessor paid a fixed sum to the lessee for its cancellation.

Held, that the amount so paid by the lessor constitutes a business expense and that he may deduct an aliquot part thereof in his return for the year in which the lease was canceled and for each succeeding year the lease had to run. (C. B. 2, page 112; O. D. 397.)

The theory of the foregoing ruling would seem to be that the lessor made a capital investment in something he had disposed of, viz., the use of property which had been leased to another.

If the life of the lease does not extend beyond the taxable

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[60] C. B. 2, page 112; O. D. 516.

period, there is no doubt that the entire amount is deductible in the period.

Rulings. A lump sum paid as damages by the lessee of business premises, by reason of the cancellation of a lease for a term of years, is deductible for the year in which paid or accrued. (B. 28-21-1726; O. D. 974.)

B owned a lease which expired in 1921. A, in order to procure this lease at the expiration of B's term, agreed to pay to the lessor, in addition to a lump sum of 3*x* dollars for the lease for the period from 1921 to 1941, *x* dollars for each of the years 1917, 1918, 1919, and 1920.

Held, that the advanced payments were in effect a bonus and constituted a capital outlay representing additional cost of the leasehold acquired, and may not be construed as an ordinary or necessary expense of doing business for any year prior to the possession of the lease. (B. Digest 50-21-1973; A. R. R. 676.)

The amount of a bonus paid by a corporation to secure immediate possession of a theatre under a lease which was limited to the taxable period, and attorneys' fees in connection with the transaction, constitute necessary expenses or costs of operation for such period and are not required to be capitalized. (C. B. 3, page 109; A. R. R. 178.)

When March 1, 1913, value affects deduction for rent.—

Ruling. The value as of March 1, 1913, of a leasehold acquired prior to that date, cannot be used in determining the amount deductible each year by the lessee when the leasehold was acquired on the basis of annual rental payments equal to a percentage of the income derived from the leased property, no specified sum having been paid in addition to the annual rentals. The amount deductible by the lessee each year is the rental payment. (C. B. 3, page 144; O. D. 675.)

The facts in the foregoing case are not stated and no intelligent criticism is possible, but comment is made because in many cases, similar on their face, lessees would be entitled to deductions in excess of the annual rental payment. If the rental were on a sliding scale it is probable that the lease would have had no capital value at March 1, 1913, but if the percentage were on a fixed basis it is quite possible that the lease would have had a substantial value.

Department store buildings are frequently leased on the

basis of annual rental payments equal to a percentage of the gross sales. If A leased a building to B for 20 years in 1903 on a basis of 2 per cent of sales and in 1913 the current rate was 7 per cent, B thereafter could deduct annually an amount in excess of the rental paid equal to a proportion of the capital value remaining on March 1, 1913. That is, if the value of the lease on March 1, 1913, was $100,000, B could deduct $10,000 annually for 10 years in addition to the rental payment.

Cost of lease may be apportioned over term as rent.—

REGULATION. Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. . . . . (Art. 109.)

When a premium is paid to secure a lease, the amount represents an additional expense of doing business, the effect being the payment of a higher rent. The proper method of handling it is to set up the amount paid as a deferred asset, charging off each year the proportion of the premium which has expired. Since it represents increased rent, the rent paid and the proportion of the premium should be carried into the expense account as one item.

A corporation issued $100,000 of its capital stock to pay for a leasehold having 31 years to run. The question arose as to how it should be treated in the accounts. If the value placed upon the leasehold was not excessive, the transaction was the same as if the corporation had sold its stock for cash and had then purchased the lease for cash. In that event it would have been proper to charge off each year as an expense one thirty-first of the amount paid.

RULING. In March, 1920, a taxpayer leased certain property, the lease to be effective October, 1922. To obtain the lease the lessee paid to the lessor x dollars to cover the period intervening between the date of the execution of the lease and date the lease becomes effective.

Held, that the sum paid in 1920 by the lessee for the privilege of

securing this lease is a business expense and is a proper charge against the taxpayer's business for the period from March —, 1920, to October —, 1922, and is to be apportioned over that period. (B. 35-21-1793; O. D. 1013.)

The payment for the period intervening is treated as an ordinary rental disbursement. Only the amount which applies to the taxable period may be taken as a deduction.

RULING. The commission paid by the lessor to a broker for negotiating a long-term lease should not be prorated over the term of the lease but constitutes a proper deduction in computing net income for the year in which paid or accrued. (I-4-40; I. T. 1171.)

It is difficult to distinguish the foregoing ruling from office decision 1013, quoted above.

Deferred payments to lessor deductible when accrued.—

RULING. Under the terms of a lease of real estate it is provided that the lessee may withhold for the first three years of the life of the lease a certain part of the annual rental in order that it may conserve its liquid assets. The amounts so withheld are to be paid to the lessor in monthly installments during the remaining life of the lease. In the event of the cancellation of the lease the amounts so withheld are agreed to be an absolute liability of the lessee. The books of the lessee are kept on the accrual basis.

Held, that the amount of the rental withheld by the lessee during each of the first three years of the lease may be accrued as an expense for that year and deducted from gross income in its return. (C. B. 4, page 141; O. D. 794.)

Rentals paid by professional men and others.—Under the title, "Business expenses of the professional man" (page 862), will be found a full discussion of this topic.

Business Expenses Distinguished from Capital Outlay

Organization and similar expenses.—The Treasury rulings forbid the deduction of attorneys' fees, accountants' fees, fees paid to state authorities and other expenditures usually grouped under the phrase "organization expenses." On this point the rulings are in direct conflict with good accounting practice.

REGULATION. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are ordinarily capital expenditures, but where such expenditures are limited to purely incidental expenses, a taxpayer may charge such items against income in the year in which they are incurred. (Art. 582.)

The foregoing regulation, unlike the same article in Regulations 45,[61] accords at least in part, with the following, which may be taken as a fair reflection of present accounting practice:

Formerly if the expenses incurred in the organization of the company (such as incorporation fees, legal, engineering and other expenses, engraving bonds and stock certificates, transfer fees and stamps, etc.) were more than could fairly be charged into current expenses, it was considered permissible to spread such charges over a term of years, preferably three, but not more than five. Sentiment is changing as to the wisdom of spreading these expenses over more than three years. The best practice is to charge off immediately everything which has no tangible or residual value. The benefit from such items cannot be compared to advertising and exploitation expenses. It is a fallacy to assume that stock certificates, incorporation expenses, etc., have any of the attributes of an asset; and so the sooner the cost appears in the expense account, the better.

The old theory of deferring part of the charge to income was sound enough, but the rule has been abused; and so we now find apportionments over five years or longer. In some cases all organization expenses, using the term in its broadest sense, are permanently capitalized. The author advocates charging off all such expenses as they are incurred.[62]

If the expenses are actual and are incurred in good faith, they constitute deductions which should be allowable for the period during which they appear on the books as charges to expenses. If a corporation actually capitalizes the items, of course it must not claim credit for the deduction; but if it follows proper and now almost settled corporate practice, this class of expenditures should appear in its books as ordinary expenses. If state laws are complied with and the usual fees are charged and paid, certainly such expenses are necessary

[61] **[Former Procedure]** For text and criticism of past practice, see *Income Tax Procedure*, 1921, pages 719-720.

[62] *Auditing, Theory and Practice* (3rd edition), R. H. Montgomery, page 576.

to the operation of the corporation. The fact that the items are not recurring ones seems to have had something to do with the former procedure of the Treasury. Anyone familiar with corporate affairs knows that thousands of items occur once only, but nevertheless are ordinary and necessary.

Expenses incurred in selling capital stock.—

REGULATIONS. . . . . If the stock is sold at a discount, the amount of the discount is not a loss deductible from gross income. . . . . . (Art. 543; Reg. 45, Art. 542.)

Any and all expenses incidental to or connected with the selling of the capital stock (common or preferred) of a corporation for the purpose of raising capital to be by it invested in property or employed in the business for which the corporation is organized are not an "expense of operation and maintenance" within the meaning of this title, and such expense is not an allowable deduction from the gross income, for the reason that such an expense is incurred in a capital transaction; that is, the raising of capital to be invested or employed in the business. . . . . (Reg. 33, 1918, Art. 145.)

The comments on organization expenses[63] apply to the foregoing regulation. Of course discounts on capital stock are not business expenses; but ordinary expenses of securing capital should not be capitalized. If it is not proper to capitalize an expense item it should be an allowable deduction as a business expense.

REGULATION. . . . . A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary. . . . . (Art. 582.)

Assessments on stock.—The following ruling holds that voluntary assessments paid by security holders are not deductible by them as business expense:

REGULATION. . . . . Amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to

[63] See page 907.

be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. . . . . An assessment paid by a stockholder of a national bank on account of his statutory liability is ordinarily not deductible. . . . . (Art. 293.)

RULING. The payment of a statutory assessment under State law against a taxpayer as a stockholder of a bank is not a deductible loss in the year paid but is an additional capital expenditure which must be added to the original cost of his stock. Gain or loss can not be determined until the stock is sold or otherwise disposed of in a closed transaction. (B. Digest 30-21-1744; A. R. R. 588.)

An answer to a question in the *Primer* makes the general statement that "assessments made by a corporation on its capital stock are regarded as further investments of capital and do not constitute an allowable deduction in the return of the individual."[64]

If the assessments result in losses, credit may be claimed for the payments. If sustained prior to 1918 the deductions will be subject to certain limitations.[65]

In another answer, the *Primer* states that in the case of a mutual irrigation company, "assessments in proportion to stockholdings merely to raise funds to keep the irrigation system in usable condition and not to make extensions or betterments" may be deducted.[66]

Expenses incurred in purchase of treasury stock—part of cost.—

RULING. The expenses, exclusive of the purchase price, incurred by a company in purchasing its own stock for the purpose of retirement or holding as treasury stock, are not such expenses as can be classified as ordinary and necessary expenses incurred in carrying on the business, and hence are not deductible from gross income. These expenses are to be considered part of the purchase price of the stock retired. (C. B. 4, page 286; O. D. 852.)

Legal payments by corporations fall into three classes: (1) capital expenditures which have a continuing benefit, (2) payments to stockholders, (3) necessary expenses.

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[64] *Income Tax Primer,* 1918, question 70.
[65] See Chapter XXIX, "Deductions for Losses."
[66] *Income Tax Primer,* 1918, question 71.

If the payments on account of stock returned to the treasury are made to stockholders, the above ruling is sound. If the expenses are ordinary and necessary, are not distributions to stockholders, nor expenses having a continuing benefit, they should be claimed as allowable deductions.

Deferred charges—advertising, etc.—

Ruling. A corporation conducted in its taxable year a national campaign of advertising its manufactured product. Inquiry is made as to whether this expense of advertising must be charged off as an operating expense during the year in which it was incurred, or whether it can be carried as a deferred asset and charged off over a period of years.

It is held that the expenses of such advertising campaign are deductible as a business expense only in the return for the year in which such expenses were paid or in the year in which liability therefor accrued, if the books of the company are kept on an accrual basis. (B. 38-21-1829; O. D. 1039.)

It has been the custom of some concerns to spread extraordinary expenditures over a period of years. If the future will assuredly receive some benefit therefrom, the policy is sound enough. (See "Organization and similar expenses, etc.," page 907.) But any doubt should always be settled in favor of an immediate absorption. If these expenditures are deductible at all, the proportion actually charged to profit and loss is the only part which should be deducted in the income tax return. In other words, it would be improper to deduct all expenditures in one year if in the books of account a proportion thereof was deferred to later periods.

Repairs and depreciation.—

Regulation. The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. . . . . (Art. 103.)

The tendency of some inspectors is to question deductions for repairs on the theory that the usual depreciation allowances include ordinary maintenance.[67] The law permits deductions for maintenance and operation in addition to depreciation. The necessity for allowing both claims is very well expressed in a recent decision.[68] The court said:

DECISION. It will thus be seen that the deductions allowed are to include, not only ordinary and necessary amounts actually paid out in the operation of the property, but also the amounts paid out in the maintenance thereof, and in addition a reasonable sum for depreciation, if any. Now, the operation of a business or property includes payment for labor and materials which go into the actual operation thereof, while maintenance means the upkeep or preserving the condition of the property to be operated, and therefore, in my judgment, includes the cost of ordinary repairs necessary and proper from time to time for that purpose. "Depreciation," as used in the statute is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property, in spite of ordinary current repairs.

Equipment purchased on so-called rental plan.—In many cases equipment is purchased and title is reserved in the vendors until final payment is made. In the meantime the payments on account are treated as rental.

Technically, the payments may be looked upon as expenses because failure to pay the final instalment might result in the repossession of the equipment by the vendor, but in the case of solvent taxpayers the whole transaction is merely a purchase on the instalment plan. The entire purchase price should be set up as an asset on one side and as a deferred liability on the other. Depreciation should be written off as if the equipment were owned.

If the rentals are charged as expenses it would be neces-

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[67] See Chapter XXXI, "Deductions for Depreciation."

[68] *The San Francisco & Portland Steamship Co. v. Scott*, 253 Fed. 854. (T. D. 2773, November 8, 1918.)

sary to include the entire purchase price (less depreciation) as taxable income for the year when title passes.

Cost connected with title to property not deductible.—

REGULATION. . . . . The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. . . . . (Art. 293.)

The cost of perfecting title is a proper capital charge, but the cost of defending title may not add anything to the value of the property. If not, the item is a business expense.

Expenses of obtaining return of property from Alien Property Custodian not deductible.—

RULING. Attorneys' fees paid for services rendered in securing for a non-resident alien, the return of property and income from the Alien Property Custodian, are not allowable deductions from gross income. If the Alien Property Custodian returned property, as distinguished from money, the attorneys' fees should be treated as a part of the cost price of the property. If the Alien Property Custodian took over property, converted it into cash, and delivered money to the taxpayer, the attorneys' fees constitute an offset against the selling price. (B. Digest 39-21-1842; O. D. 1048.)

It is unlikely that expenses incurred in connection with the recovery of seized property add to its value. If not, such expenses should be treated as business expenses.

Architect's fee not a business expense.—

REGULATION. . . . . The amount expended for architect's services is part of the cost of the building. . . . . (Art. 293.)

Cost of copyright and plates not deductible.—

REGULATION. . . . . Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. . . . . (Art. 293.)

In the two foregoing cases the payments are properly designated as capital, but it should be noted that the items become allowable deductions as depreciation when spread over a term of years.[69]

[69] See Chapter XXXI.

Title abstract companies—maintenance of records.—

RULINGS. Title abstract companies incur relatively large and continuous expenditures in keeping their plants up to date, such as the expense of adding and incorporating in the plant records that are being made daily in the various courts and in the Recorder's office.

These records which are added to and incorporated in the plant for the purpose of keeping it in up to date running order and preventing depreciation are in the nature of ordinary and necessary repairs. The expenses, therefore, incurred in making such records are current expenses, and as such are deductible for the year in which incurred and paid or accrued.

Since a title plant is not an asset of a nature which gradually approaches a point where its usefulness is exhausted, but is an asset of a more or less permanent character, it is not a proper subject of a depreciation allowance. (B. 36-21-1799; O. D. 1018.)

The cost of land title abstract books purchased is a capital expenditure. The expenditure for them may not be deducted as a loss by reason of the purchaser's claim that they are of no service to it because it already owns another set of the same records. (B. 39-21-1843; O. D. 1049.)

Carrying charges on real estate.—A distinction must be drawn between operating expenses, which can be charged as necessary expenses of doing business, and expenses which arise when there is no going business which can be charged.

Unproductive real estate is a case in point. There may be taxes, interest and other items of expense to be taken care of and no income out of which the payments can be made.

Capital must be used to make the payments, and in the circumstances the items will be regarded as capital expenditures. As soon as a property is being operated or used the capitalization of charges must cease, even though the property is being operated at a loss. If a property is only partly operated the charges may be partly capitalized.

When several properties are under one ownership, it is the custom to absorb the charges on the unproductive properties in the surplus income from productive property. There is no objection to this from a conservative accounting point of view. As long as capital gains were subject to high surtaxes, it was in many cases to the taxpayer's advantage to

capitalize expenses on unproductive property, rather than to charge them off immediately, so as to minimize the amount to be reported as taxable profit in the year of sale. With the low rate of tax on capital gains, however, it will now be to the advantage of the taxpayer to have the profit on realization as large as possible and to get credit from year to year against income subject to high surtax rates for the carrying charges.

Payments for goodwill not an expense.—In some cases payments are made which are of the nature of goodwill rather than expenses. Such payments should not be claimed as deductions even though it is decided that they should not be capitalized. Payments to a retiring partner, when in excess of reasonable compensation for services rendered, should be charged to goodwill and not to expenses.

Payments under leases or to officers of corporations in excess of reasonable compensation for the use of property, or for services, are not ordinary or necessary expenses of a business.

Payments which properly are chargeable either to expenses or to capital, such as development and establishment expenditures, should not be charged on the books as expenses unless it is proposed to claim credit therefor as allowable deductions.

Miscellaneous

Lobbying expenses and campaign contributions not deductible.—

REGULATION. . . . . Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income. (Art. 562.)

Lobbying expenses will probably appear under legal expenses and will no doubt be allowed. In the case of corporations, campaign contributions are illegal and should not appear in the books. The words "advertising other than trade

advertising" were not used in Regulations 33 which were in force until 1919. Advertising Liberty bonds certainly is not trade advertising, but has been allowed. It would be held that any advertising for the good of a business would be an allowable deduction.

Trading stamps expenditure a business expense.—The Treasury in the Regulations 45 and 62 has provided in a very definite manner for the deduction of trading stamp expense, in effect reversing the earlier ruling that a reserve set up as a liability equal to the redemption value of the stamps is not deductible.[70]

Regulation. Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing (*a*) the total issue of stamps during each year, (*b*) the total stamps redeemed in each year, and (*c*) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required. (Art. 91; Reg. 45, Art. 88.)

In effect the foregoing regulation permits the deducting of reserves set up for trading stamps. Likewise, similar reserves should be allowed for cash discounts because the same principle is involved. (See page 451.)

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[70] **[Former Procedure]** A reserve set up was not deductible under an earlier regulation. (Reg. 33, 1918, Art. 141.)

Maintenance funds required by law should be deductible.—

RULING. Payments to trustees by a cemetery corporation during the taxable year of a certain percentage of the proceeds of sales of cemetery lots set aside for a maintenance fund to be controlled solely by the trustees thereof are not deductible from the gross income of the corporation even though such payments are required by state law. (C. B. 2, page 216; O. D. 529.)

The author is of the opinion that the foregoing ruling is erroneous, and that it should be changed to accord with the principle laid down in article 567,[71] whereby banking corporations are allowed to deduct "depositors' guaranty funds" when such funds are required by law.

Dues paid to chambers of commerce and associations deductible.—

RULING. Membership fees or dues paid by individuals and corporations to a chamber of commerce or board of trade are deductible from gross income as a business expense provided the membership is employed as a means of advancing the business interests of the individual or corporation. (C. B. 2, page 105; O. D. 421.)

Likewise, fees paid to trade associations to promote the general business interests are also deductible.[72]

Payments for baseball players.—

RULING. An amount paid by a baseball club to another baseball club as the purchase price of a contract between such club and a player covering the services of the player for a period of more than one year is deductible from gross income during the life of the contract, a proportionate part of the price paid being deductible each year. (C. B. 4, page 142; O. D. 836.)

Dues paid to labor unions.—

RULING. Dues paid by an individual to an organized labor union are deductible as a business expense in computing his net income for income-tax purposes. (C. B. 2, page 105; O. D. 450.)

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[71] See page 902.
[72] C. B. 2, page 105; O. D. 496.

Fees paid to secure employment.—

RULING. Fees paid to secure employment are considered allowable deductions for the purpose of computing net income subject to tax. (C. B. 3, page 130; O. D. 579.)

Bonus paid for an early delivery of steamship.—

RULING. A bonus was paid for the delivery of a steamship at a date earlier than that stipulated in the contract for its construction and the question is presented whether the amount is properly chargeable as a business expense or as a capital expenditure.

Held, that as the bonus paid for delivery at a date earlier than that contracted for added nothing to the value of the vessel after the contract date of delivery the amount so paid is properly chargeable as a business expense and is deductible from income received between the date of delivery of the vessel and the date it would have been delivered had no bonus been paid. (C. B. 3, page 131; O. D. 664.)

Earnings paid city, etc., by public utility an expense.—

REGULATION. . . . . In the case of a public utility acquired, constructed, operated, or maintained by a taxpayer under contract with any State, Territory, or political subdivision thereof, or with the District of Columbia, containing an agreement that a portion of the net earnings of such public utility shall be paid to the State, Territory, or political subdivision thereof, or the District of Columbia, the amount so paid may be deducted by the taxpayer as a necessary expense in transacting business. . . . . (Art. 87; Reg. 45, Art. 84.)

Payments by railroads to Interstate Commerce Commission.—

RULING. Under the provisions of section 15—A of the Interstate Commerce Act, as amended by the Transportation Act approved February 29, 1920, railroad corporations are required to pay to the Interstate Commerce Commission one-half of their net railway operating income in excess of 6 per cent on their invested capital. It is understood that such payments are absolute, the railroad company having no present or future rights therein.

Held, that any sum so paid may be deducted in the taxable year in which paid or accrued, dependent upon whether the books of the corporation are kept upon a cash receipts and disbursements or accrual basis. (B. 32-21-1762; O. D. 989.)

Amounts paid on judgments or other binding adjudications.—

REGULATION. . . . . Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated[73] or paid, unless taken under other methods of accounting which clearly reflect the correct deductions, less any amount of such damages as may have been compensated for by insurance or otherwise. . . . . (Art. 111.)

The present regulations are very definite in holding that losses which occur in one year and which are not discovered until a later year cannot be deducted in the later year, but are only deductible as of the time when they actually occurred. The principle applies to all kinds of expenses. Exception is made only for overlapping items which do not materially disturb the income for any one year. The regulation has some merit and should be followed in most cases, but greater latitude should be given to taxpayers. If, in the opinion of the latter, true net income for the taxable year can be stated by charging items as an expense during the taxable year, taxpayers should not be forced to make amended returns for prior years.

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[73] **[Former Procedure]**

RULING. A corporation was sued for infringing a trade-name covering a period ending in 1912. Judgment was obtained in 1916. The Treasury Department holds that the amount of this judgment should be prorated over the period ending in 1912, according to the income of each year. Such part of it as by this method is found applicable to the income of the corporation for the period 1909 to 1912, would be referable to those years but no part of this sum would be deductible in the return of income for 1916.

The same corporation also paid in 1916 an additional sum as consideration for dismissal of a pending suit for interest on the above judgment from the date of the decision of the Circuit Court of Appeals to the date of payment and for the unrestrained use of the trade-name in question. The Treasury Department holds that if this amount "can be segregated between *interest* and *use,* it would be treated the same as in the other case, for the period subsequent to 1912, and such part thereof as shall be thus found applicable to the 1916 income would be deductible in the return of income for that year under the respective heads of "business expense" and "interest," and if segregation has not been or cannot be made, the entire amount may be treated as "business expense" to be prorated as above indicated." (Substance of letter to The Corporation Trust Company, signed by Commissioner W. H. Osborn and dated February 9, 1917.)

The inevitable result would be that for years to come taxpayers will be finding that expenses, which ordinarily would and should be charged to current operating accounts, occurred during the years 1918 and 1919 when the tax rates were very high and, acting under the letter of the regulations, amended returns will be made with a resulting saving in tax.

The 1922 regulations appear to modify the rule in cases when taxpayers have actually provided in prior periods for losses finally determined in later years. It is provided that judgments, etc., are deductible in the years when paid "unless otherwise provided for by the taxpayer's method of accounting." It is to be hoped that this refers to reserves which have been set up for accruing and estimated losses and liabilities set up in good faith in order to reflect true net income.

Deductions for probable but uncertain expenses.—

Ruling. A report of a master in chancery, appointed by an interlocutory decree in a suit for damages for alleged infringement of a patent, assessing damages against the taxpayer, which report was filed during the taxable year, but was not confirmed until the following year when judgment was entered on the report, can not be regarded as a determination of the amount of the claim, and no deduction for the taxable year is permissible in regard to the judgment referred to. (C. B. 1, page 207; S. 923.)

The question involved in the foregoing is a difficult one to discuss. If it appears that an expense has been incurred but its amount is doubtful, good accounting practice and conservative business methods demand that an estimate be made and entered in the books. It would be a dangerous practice to omit a liability from the books merely because the *exact* amount thereof was unknown. The law permits the deduction of necessary business expenses and expressly approves the accrual system of accounting. It is therefore safe to assume that when during a taxable year an expense has been incurred or when it is so probable that an expense has been incurred that good practice requires the setting up of the transaction as a liability, the amount of the expense (even though it is an

estimate) when entered in the books in good faith will be held by the courts to be deductible in the same period. The controlling idea is that the income of a future period should never have to bear expenses which belong to a past period. The law need not be amended to effect this. The author has no serious criticism to make of the practice of requiring amended returns so long as the Treasury is consistent, but *in no case* should substantial expenses and losses applicable to a past period be carried forward to a subsequent period when the taxpayer has made provision for such expenses in the period to which the expenses are chargeable.

Ruling. A reserve to cover a contingent liability, representing an estimated amount of claims actually outstanding at the close of the year, which will be paid on account of loss and damage to freight and injuries to persons, is not deductible. Such amounts are deductible only for the year when the claims are put in judgment or paid. (C. B. 4, page 142; O. D. 879.)

Payments to trustee for the ultimate benefit of the taxpayer not deductible.—

Ruling. Pursuant to the requirements of its by-laws a corporation entered into a trust agreement under the terms of which a sum amounting to not less than a certain per cent of the corporation's paid-in capital stock must be turned over to the trustee annually until a fund has accumulated amounting to x dollars, inclusive of the interest which is required to be added to the principal, when the income therefrom is to be turned over annually to an executive committee of the corporation for a purpose related to the business of the corporation.

Held, that the amounts paid to the trustee by the corporation are not deductible from its gross income.

The interest accruing to the fund is income of the corporation which should be reported by it in its return. (B. Digest 39-21-1840; O. D. 1047.)

Attorney's fees paid by maker of illegal sales, not deductible.—Attorney's fees paid by a proprietor of a retail business, who was fined and imprisoned for making illegal sales, have been held to be personal.[74]

[74] C. B. 4, page 209; O. D. 952.

The foregoing ruling holds in effect that *gross* income earned illegally is taxable. The theory may be commendable but it is doubtful if the ruling is sound. If it is, many other deductions arising from illegal transactions would not be deductible.

It has also been held that a fine paid by a corporation for violation of the Anti-Trust Act is not deductible as an ordinary and necessary expense.[75]

[75] I-4-45; I. T. 1174.

CHAPTER XXVII

DEDUCTIONS FOR INTEREST

The passage of the 1918 law greatly simplified the procedure for deducting interest paid. Previous laws had imposed restrictions upon corporation deductions for this purpose, making it necessary to distinguish interest payments very sharply from other payments.[1] The only change in the 1921 law is that the restriction on interest paid to carry tax-exempt securities is extended to Victory 3¾ per cent notes not owned by original subscribers.

Deductions allowed to individuals.—

LAW. Section 214. (a) . . . . (2) **All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;**[2] . . . .

Deductions allowed to corporations.[3]**—**

LAW. Section 234. (a) . . . . (2) **All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness in-**

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[1] The arbitrary restriction imposed by the 1913 and subsequent laws, its effect and the proper method of arranging the accounts in order to prevent unnecessary burdens are fully discussed in *Income Tax Procedure*, 1919, pages 454-463.

[2] **[Former Procedure]**

1917 LAW. Section 5. "(a) . . . . Second. All interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title; . . . . "

This restriction was introduced by the 1917 law. Before that time an interest deduction was not disallowed because incurred for the purchase of tax-exempt securities. The 1918 law introduced the words "or carry" in speaking of tax-exempt securities.

[3] For a discussion of the limitation which formerly applied in the case of corporations, see *Excess Profits Tax Procedure*, 1921.

curred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; . . . .

Regulation. Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry securities, such as municipal bonds and first Liberty loan 3½ per cent bonds, the interest upon which is wholly exempt from tax, is not deductible. This exception, however, does not apply in the case of 3¾ per cent Victory notes originally subscribed for by the taxpayer, and interest on indebtedness incurred to purchase or carry such notes is deductible. Since other obligations of the United States issued after September 24, 1917, are not wholly exempt from taxation under this title, interest paid on indebtness incurred or continued to purchase such obligations (whether or not originally subscribed for by the taxpayer) is deductible in accordance with the general rule. (Art. 121.)

This article has been changed so as to provide for the change in the deductibility of interest paid to carry 3¾% Victory notes.

Interest which is deductible.—All interest paid on indebtedness by an individual or a corporation is deductible, except interest paid on money borrowed to purchase or carry certain securities the interest upon which is wholly exempt from taxation.

United States obligations issued prior to September 24, 1917, including first or 3½ per cent Liberty bonds, are exempt from taxation and interest on money borrowed to purchase or carry such obligations is not deductible. This date, September 24, 1917, marked a change in policy by the United States government. The understanding was that after that date securities entirely exempt from taxation were not to be issued, and, consequently, the restriction on the deduction for interest was not applied to interest paid on money borrowed to carry obligations of the United States issued thereafter.[4] The

[4] [Former Procedure] The 1917 law did not allow as a deduction interest paid on indebtedness incurred for the purchase of obligations of the United States issued after September 24, 1917, to the extent to

3¾ per cent Victory notes issued in 1919 are entirely free from taxation. Sections 214 and 234 of the 1921 law provide that interest on money borrowed to purchase or carry the 3¾ per cent notes is deductible in income tax returns only when the notes are in hands of original purchasers. When the campaign for their sale was being made, one of the most potent arguments used was that a taxpayer who had a large income from other sources might borrow money to buy the tax-exempt Victory notes and secure a net return on a margin of 10 per cent invested in the bonds of as much as 26 per cent per annum. In some cases banks advanced 100 per cent of the amount required to buy the bonds and represented to taxpayers that they would realize a large profit (through the reduction in taxes) without any investment. The size of the savings, of course, depended on several factors: (1) the market price of the notes; (2) the margin required; (3) the rate of interest charged by banks on the loans; and (4) the size of the tax rate.

In disallowing the deduction of interest paid to carry Victory notes other than original subscriptions, the Treasury cannot be accused of a breach of faith because the representations made were only in connection with the original subscriptions to the various issues after the first. The mere fact that other

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which any part of the interest from such obligations was tax-exempt. The 1917 law entirely omitted the reference to obligations of the United States, and it was therefore held that any interest paid on indebtedness in respect of the $5,000 of second Liberty bonds (the interest on which principal amount of bonds was exempt) was not deductible. This restriction was made effective by the following directions in section E, page 2 of income tax form 1040 (revised January, 1918):

INTEREST ON BONDS AND OTHER OBLIGATIONS OF THE UNITED STATES ISSUED SINCE SEPTEMBER 1, 1917.—

Interest paid. "If indebtedness has been incurred for the purchase of such obligations, find what percentage the amount of such obligations held in excess of $5,000 is of the total amount of such obligations held, and enter in column 5 the same percentage of the interest paid on the indebtedness."

Under the 1918 law interest paid on money borrowed to purchase or carry Victory 3¾ per cent notes was fully deductible.

than original subscribers were given the same advantage under the 1918 law was really a gift by Congress, which it was quite at liberty to withdraw at any time on reasonable notice.

It is urged that Congress commits a distinct breach of faith in retroactively taking away the deduction, that it should have been continued at least until the act containing its repeal was introduced in Congress.

INTEREST ON SCRIP DIVIDENDS DEDUCTIBLE.—

REGULATION. Interest paid by a corporation on scrip dividends is an allowable deduction. . . . .

INTEREST ON CERTIFICATES OF DEPOSIT DEDUCTIBLE.—

. . . . In the case of banks and loan or trust companies, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. (Art. 564.)

INTEREST ON REAL ESTATE MORTGAGE DEDUCTIBLE.—

REGULATION. . . . . Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. . . . . (Art. 121.)

SHOULD DISCOUNT ON BONDS BE TREATED AS PAYMENT OF INTEREST?—Bonds usually sell at a discount because the interest is fixed at a lower rate than the purchasers of the bonds think the debtor corporation should pay. Under proper accounting methods the discount is distributed ratably over the life of the bonds. The annual interest paid plus the annual proportion of discount together form the true cost.

REGULATION. . . . . If it [a corporation] sells its bonds at a discount, the amount of such discount is treated in the same way as interest paid, ... (Art. 563.)

The Treasury in the past treated the discount as a loss;[5] therefore the discussion of bond discounts as a deduction will be found in Chapter XXIX, "Losses."

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[5] Article 135, Regulations No. 33.

Bank of deposit may deduct interest paid on deposits even though most of the assets consist of tax-exempt bonds.—An interesting question arises in the case of a bank which pays interest on deposits and invests most of its assets in tax-exempt bonds. A bank had capital and surplus of $1,000,000 and deposits of $10,000,000. Its funds were so invested that the income was as follows:

From tax-exempt sources (chiefly municipals)		$300,000
From other sources		350,000
Total income		$650,000
Expenses:		
Interest paid to depositors	$250,000	
Expenses	100,000	350,000
Net income		$300,000

The interest from tax-exempt bonds not being returnable the bank was not subject to the federal income tax.

Ruling. It is the ruling of this office that a bank doing a commercial business and receiving deposits upon which it pays interest is entitled to deduct from its gross income shown upon its annual tax return the full amount of interest paid to its depositors. The payment of such interest is one of the ordinary and necessary expenses in the carrying on of its banking business. Although the deposits constitute indebtedness of the bank, such indebtedness was not incurred and is not continued for the purpose of purchasing or carrying obligations, even though the deposits are invested in bonds or other obligations the interest upon which is wholly exempt from income and excess profits tax. (Letter to Lybrand, Ross. Bros. & Montgomery, signed by Commissioner Roper, June 24, 1919.)

Interest on overdue federal taxes is deductible.—Interest accrues very rapidly on assessments of additional taxes for 1917 and prior years which are the subject of claims in abatement. Many taxpayers, when additional taxes are paid, treat the entire payments as tax payments. Since federal taxes are not allowable deductions but interest is fully deductible, it is important to separate the payments.

Ruling. Interest paid or accrued under the provisions of section

250 (a), (b) and (c), Revenue Act of 1918 is deductible under the provisions of section 214 (a) 2 or section 234 (a) 2 in computing net income. (C. B. 2, page 227; O. 922.)

State taxes deductible as interest—when?—Notwithstanding the phrase "or any other tax paid pursuant to the contract"[6] a regulation has been issued stating that a corporation paying a state tax or any other than a federal tax for someone else pursuant to its agreement may deduct such payment as interest paid on indebtedness. This regulation is as follows:

Regulation. Corporations may deduct taxes from gross income to the same extent as individuals, except that in the case of corporate bonds or obligations containing a tax-free covenant clause, the corporation paying a Federal tax,[7] or any part of it, for some one else pursuant to its agreeemnt is not entitled to deduct such payment from gross income on any ground. In the case, however, of corporate bonds or obligations containing an appropriate tax-free covenant clause, the corporation paying a State tax or any other than a Federal tax for some one else pursuant to its agreement may deduct such payment as interest paid on indebtedness.[8] (Art. 565.)

The foregoing is an unusually liberal interpretation of the law.

Bank charges on tax-exempt obligations may be deducted.—

Ruling. Interest paid by a contractor on funds advanced by a bank and discount charged by the bank for cashing municipal certificates of indebtedness are deductible from gross income. (B. 34-21-1778; O. D. 999.)

Interest on dividends paid by court order deductible.—

Ruling. Where a court of original jurisdiction entered a decree in 1917 requiring a corporation to distribute dividends, and upon an

[6] Section 234 (a-3).

[7] [Former Procedure] In the earlier edition of Regulations 45 in place of the phrase "paying a federal tax" there appears this expression "paying a tax . . . . whether federal, state or otherwise." The regulation was inaccurate as state taxes are and always have been deductible.

[8] Tax paid under a tax-free covenant clause is not to be included in the gross income of the obligee. See page 678.

appeal the decree was affirmed by a court of last resort, which in addition to confirming the decree of the lower court awarded interest on the amount of the dividends from the date of the decree of the lower court to the date of payment, such interest is deductible from the gross income of the corporation for the year in which paid, ... (C. B. 4, page 141; O. D. 778.)

INTEREST ON CONSTRUCTION IS DEDUCTIBLE IF NOT CAPITALIZED.—

RULING. Interest and taxes paid by a corporation in connection with the construction of its original plant are deductible from its gross income under the Revenue Act of 1913, even though such payments are properly chargeable to capital account and are so charged by the corporation on its books, provided the corporation amends its returns so as to exclude the interest and taxes so deducted from capital account. (C. B. 1, page 109; S. 935.)

Interest which is not deductible.—Generally speaking, the only interest on borrowed money which is not deductible is that paid on indebtedness created or continued to purchase or carry state and municipal bonds, United States bonds issued prior to September 24, 1917 (including Liberty 3½'s), Farm Loan bonds, and United States Victory 3¾'s not originally subscribed for.

INTEREST LIMITATION IS SOUND.—The restriction on the deduction is sound. It was made imperative by the establishment of very high income tax rates. So long as the rates of the tax were low, there was no appreciable inducement to a taxpayer to borrow money with which to buy tax-exempt securities. Under very high surtax rates the situation changed. For instance, a taxpayer subject to income taxes averaging 40 per cent of his income would find it profitable to buy tax-exempt securities on a large scale. He might purchase $1,200,000 of tax-free 3½ per cent bonds and borrow against them $1,000,000. If he paid 4 per cent interest on the loan, he would be in the position of receiving $42,000 per annum not subject to any tax, and an allowance of $40,000, which would be a clear deduction from all taxable in-

come. If $40,000 of his income was subject to 40 per cent surtax he would avoid his just taxes to the amount of $16,000 for the year. As heretofore stated, such saving in taxes is possible in the case of the 3¾ per cent Victory bonds, if originally subscribed for.

SEGREGATION OF INTEREST PAID WHEN BOTH EXEMPT AND NON-EXEMPT SECURITIES ARE USED AS COLLATERAL.—It is assumed that a borrower would use tax-exempt securities (excepting 3¾ per cent Victory bonds originally subscribed for) as collateral only when no other collateral is available. When the collateral consists entirely of tax-exempt securities, no part of the interest paid on the borrowed money is deductible.

When the collateral consists entirely of securities not tax-exempt or of any United States bonds issued after September 24, 1917, and originally subscribed for by the taxpayer, the entire interest paid is deductible.

When the collateral consists of both classes, part of the interest paid is deductible and part is not deductible.

There are at least two methods in use for determining the amount of deductible interest which are not entirely accurate:

1. By claiming as deductible the same proportion of the total interest paid as the taxable interest received on bonds pledged is of the whole amount of interest received on such bonds.

2. By averaging by the month the relative amounts of principal of taxable and non-taxable bonds pledged and applying the result for the year to the interest paid.

Banking houses and other taxpayers should, whenever possible, keep their securities separated so that those not tax-exempt and the 3¾ per cent Victory bonds (if originally subscribed for by the taxpayer) will be used before any others. When feasible, loans should be wholly secured by one of these two classes. This will insure the greatest saving in taxes and the least annoyance in bookkeeping.

When both exempt and non-exempt securities must be used

as collateral for the same loan, the only accurate method of segregating the interest paid is the following:

3. Since collateral loans are made by lenders on the market value of the securities pledged, and not on their par value or income-producing basis, interest paid on loans should be apportioned between exempt and non-exempt securities in the ratio that the market value of one class of securities bears to the other.

Federal taxes assumed by corporation issuing tax-free bonds not deductible as interest.—When collection at the source was provided for in the 1913 law it was found that many corporations had made contracts with their bondholders under the terms of which the corporations agreed to pay for the bondholders any taxes they might be required to retain out of interest due the bondholder. These contracts were supposed to influence favorably the terms upon which bonds could be sold. Under such a theory the subsequent imposition of a tax which falls within the contractual obligation means to the corporations additional cost of money borrowed—hence the equivalent of an increased interest rate. As a necessary expense of doing business, taxes paid on this account should be an allowable deduction, but on the ground that the payments constitute the voluntary assumption of taxes assessed against bondholders and not the corporations the latter are not permitted to claim credit for the payments in their tax returns either as interest or taxes.[9]

Law. Section 234. (a) . . . . (3) . . . . (c) . . . . In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title or any other tax paid pursuant to the contract . . . . shall be allowed;. . . . .

Certain ground rents not deductible as interest.—

Regulation. . . . . Payments made for Maryland or Pennsylvania ground rents are not deductible as interest but may, under proper circumstances, be deducted as rent. (Art. 121.)

[9] Under the 1921 law the obligees do not have to include such taxes in their gross income. Prior laws did not contain such a requirement but the Treasury established it by regulation.

Ground rent is defined to be a rent reserved to himself and his heirs by the grantor of land out of the land itself. It is not granted like an annuity or a rent charge, but is reserved out of the conveyance of the land in fee. It is an estate separate from the ownership of the ground, and is held to be real estate, with the usual characteristics of an estate in fee simple—descendible, devisable and alienable.[10]

A rental for other than business purposes is not an allowable deduction under the income tax, while no such restriction applies in the case of interest payments. The refusal to permit ground rents such as those described to be deducted as interest is to prevent rents of non-business character from being deducted under the guise of interest payments.

Dividends on preferred stock not deductible as interest.—

Regulation. . . . . So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at net income.[11] (Art. 564.)

Interest paid on instalment subscriptions to capital stock not deductible.—When interest was paid on the instalments due under a contract to subscribe for stock, such interest is considered as a distribution of profits and as such is not deductible.[12]

If interest is paid ratably to all stockholders it might be deemed to be a distribution of profits; but if paid to some on the theory of borrowed money and not to others, the interest payments should be treated as fully allowable.

Interest on taxpayer's own capital[13] not deductible.—

Regulation. Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business but

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[10] *Wilson v. Iseminger,* 185 U. S. 55, 46 L. Ed. 804, 22 S. Ct. 573.

[11] See page 705.

[12] B. 32-21-1765; O. D. 991.

[13] The economic term for so-called interest charged against oneself as a cost or carrying charge is "imputed" interest.

which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. (Art. 122.)

The author considers this position to be entirely sound.[14] Some concerns regard interest as an element of manufacturing cost, and, basing inventory valuations on such so-called costs, thereby overstate the inventory valuations. It is like pulling oneself up by one's own boot-straps. If the concern deducts such interest, it should logically account for it immediately as interest received. The point is covered more fully in an earlier Treasury decision, quoted in part below.

RULING. A corporation would not be permitted to include in its deductions the rental value of the property which it owns and occupies nor would it be permitted to deduct from gross income the interest which the capital invested or employed would earn were it otherwise invested.

It therefore follows that a corporation cannot take into account as a part of the cost of manufacture any possible earnings; that is, earnings which might accrue on its capital or investment had such capital been so placed as to earn a given rate of interest. (T. D. 2137, January 30, 1915.)

Accounting procedure.—

ACCRUAL BASIS IS PERMITTED.—The law clearly states the right of a taxpayer to return on either a paid or an accrual basis. Sections 214 and 234 specifically state that "all interest *paid or accrued within* the taxable year on indebtedness" shall be allowed as a deduction. From the point of view of the government and the taxpayer alike it is desirable that the interest deduction should be based upon the books of the taxpayer, provided always, of course, that the books are kept properly and honestly. Every well-kept set of books reflects the interest accrued during the year. Interest payments may and do fluctuate. Large loans may fall due on January 1 and have interest paid on December 31 in one year and on January 2 in another year. Although there may be some gain or loss in

[14] *Auditing, Theory and Practice* (3rd edition), by R. H. Montgomery, page 155 *et seq.*

taxes in the year when a change is made from one basis to the other, the net difference between the accrual and the paid basis is nothing at all over a period of years, unless the tax rate changes.[15]

WHEN ACCRUED INTEREST IS NOT DEDUCTIBLE.—

RULING. A lumber company entered into a contract for the purchase of a timber tract, agreeing to pay for the quantity of timber which it is estimated will be cut each year, payment to be made at the time each block is cut at a certain rate per thousand feet, plus interest at 6 per cent per annum from the date of contract.

Held, that inasmuch as the interest charge did not accrue and become payable until the timber was cut, it was not a proper deduction until that time. The agreement is an executory contract to purchase the timber and no interest is deductible except as the contract is

[15] **[Former Procedure]** The 1913 law permitted individuals to deduct "interest paid within the year" (section II, B) and allowed corporations to deduct interest "accrued and paid within the year" [section II, G (b) (third)]. In its interpretation the Treasury held, in the case of corporations, that to be allowable as a deduction, interest must be both accrued and paid within the same year (T. D. 1916). The 1916 law used the phrase "paid within the year" in describing the interest deductions of both individuals and corporations [section 5 (a) (second); section 12 (a) (third)]. The same law permitted the use of the accrual basis by corporations [section 13 (d)]. The ruling issued to cover this point was T. D. 2433 (January 8, 1917).

Prior to January 8, 1917, the government insisted that the interest allowance be reported on the paid basis. This worked against the government and in favor of the taxpayers, although the latter did not seek the advantage. On the contrary, most of them found the "paid" basis very objectionable and tried to change it and in many cases made up their returns in accordance with their books rather than in strict adherence to the law. A loss to the government occurred because the tax rates increased.

After that date in the case of individuals the regulations contented themselves with a general permission to make a return on a basis other than that of actual receipts and disbursements if the basis clearly reflected the income. (Reg. 33, 1918, Art. 24.) In the case of corporations, on the other hand, the utilization of the accrual basis for interest deductions was specifically authorized in the following:

REGULATION. " . . . . If the accounts of the company are kept on a basis other than actual receipts and disbursements, the amount of interest actually accrued at the contract rate . . . . may be deducted, provided it is so entered on the books as to constitute a liability against the assets. . . . . " (Reg. 33, 1918, Art. 180.)

executed. The interest payment does not constitute an operating expense of the company, but enters into the cost of the lumber produced that year. (C. B. 3, page 149; O. D. 595.)

INTEREST PAID TO PARTNERS.—From an accounting point of view interest paid to partners upon contributed capital or so-called partnership loans is an expense of the business only so far as the partners themselves are concerned. Contributions by general partners are at the risk of the business so far as creditors are concerned, and it is customary in preparing balance sheets to combine all the partners' accounts as the aggregate capital of the partnership, irrespective of how the balances appear upon the firm's books. Under income tax procedure it is of no importance to the government whether interest is allowed or paid to partners. If charged on one side of the returns as an expense, the same amounts appear on the other side as income and the tax to be paid is not affected.[16]

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[16] [Former Procedure] Under the excess profits tax law of 1917 which required a statement of invested capital and a determination of partnership profits as distinguished from the individual's net income, it made a decided difference whether or not interest on partners' loans or capital accounts were entered as a business expense.

T. D. 2613 (December 20, 1917), published as bearing on the excess profits tax only, was as follows:

REGULATION. "In computing net income for purposes of the excess profits tax a partnership will be allowed to deduct amounts paid during the year to an individual partner as interest upon any bona fide loan, but no deduction for so-called interest upon capital will be recognized."

Excess profits tax returns were based on income tax returns. Since the provision for the payment of interest was not mandatory, partnerships should not have availed themselves of the privilege unless the interest paid to partners was at a rate substantially greater than the rate of exemption (7 to 9 per cent) allowed on capital invested; otherwise the net tax paid to the government would have been greater than if interest paid to partners had not been treated as an expense of the business, because the deduction of interest as an expense made the sum lent unavailable as part of invested capital.

The case was not the same as that of partners' salaries. The allowance of salaries as an expense of the business did not diminish the aggregate capital invested; whereas if interest on partners' loans were treated as an expense, the principal amount of such loans must have been

Individual interest deduction too broad.—While Congress may be criticized because of its former policy of restricting corporation interest deductions too narrowly,[17] it may be criticized on the other hand because the interest deduction permitted to individuals is too generous. The law is supposed to proceed on the theory that the specific exemptions are sufficient to cover minimum personal living expenses—to provide the creature comforts. That was the reason given for not allowing life insurance premiums to be deducted.[18] Living expenses above this minimum are not supposed to be deductible. But if a man borrows money to buy an automobile, or places a mortgage on his house because he is living beyond his means, he is permitted under the law to deduct all such interest paid. It is clearly a living expense and theoretically should not be deductible. It would seem equitable that the law should permit the deduction of interest payments only where the interest-bearing debt was incurred in the purchase of property or investments for income-producing purposes. Such a provision raises some practical difficulties such as that of designating the particular purposes for which the proceeds of a loan are used, but these are not as a whole insurmountable.

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deducted from the total of the invested capital of the partnership and the benefit of the deduction of 7 to 9 per cent thereon was lost.

It was not suggested that the books of account should be changed to conform with the excess profits tax returns. It was not expected that the latter would agree with the books.

[17] See page 923.

[18] See Chapter XXVI, "Deductions for Expenses."

CHAPTER XXVIII

DEDUCTIONS FOR TAXES

The 1918 revenue law was generous in its treatment of taxpayers, so far as allowances for taxes paid were concerned. The changes which have been made in the 1921 law, while operating in the main to reduce the benefit that may be claimed by taxpayers, are still of so reasonable a nature that no great objections can be raised against them, with the exception of excess profits tax credits which will be mentioned later.

All taxes paid in this country, except federal income tax and certain types of special assessments, are still allowable in determining the amount of income tax payable, either as deductions from the amount upon which the income tax is to be calculated, or else as a credit towards the amount of taxes payable.

There is one important change in the law which affects both corporation and individuals receiving income from abroad, and that is the provision, inserted for the first time, that the foreign tax allowed as a credit shall not exceed the same average rate on the foreign income which the United States income and profits taxes are on the total income from both foreign and domestic sources; or, as the law puts it, that the credit taken shall not exceed the same proportion of tax against which credit is taken, which the foreign income of the taxpayer bears to his entire net income.

The provision in the law specifically allowing inheritance taxes as deductions from net income as accrued on the due date thereof, is a direct result of the Woodward case quoted on page 961.

Until this year, aliens resident in the United States who were subjects of a foreign country could deduct the amount of

"any such taxes paid during the taxable year to *such country*" if certain reciprocal advantages were granted to American citizens residing in that country. The 1921 law changes this to "the amount of any such taxes paid during the taxable year to *any foreign country* if the foreign country of which such alien resident is a citizen or subject . . . . allows a similar credit to citizens of the United States . . . ." [sec. 222 (a-3)].

The result of this change is that the citizen of Canada, for example, who formerly could only obtain credit for Canadian taxes, may now obtain credit for taxes paid to countries such as Great Britain or France, which have no reciprocal clauses in their tax laws. This means that the credit depends entirely upon the attitude of the government of which the resident alien is a national.

A new subsection[1] provides that in the case of a return made for a 1920-1921 fiscal year the credit for the entire fiscal year is to be determined under section 222, a deduction to be made therefrom, however, for any credit which the taxpayer has already taken.

Taxes Deductible

Individuals.—

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222, (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (d) taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer. For the purpose of this paragraph estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes; . . . .

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[1] Section 222 (d).

Corporations.—

LAW. Section 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . .

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, and (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed nor shall such tax be included in the gross income of the obligee. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member, which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes. For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;[2] . . . .

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[2] **[Former Procedure]** The provisions of the 1913 law relating to individuals read simply "all national, state, county, school and municipal taxes paid within the year, not including those assessed against local benefits." (Section II, B, third.) The corporation section of the 1913 law was as follows: "All sums paid by it (viz., the corporation) within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country." [Section II, G (b), fourth.]

Under the law of 1913 taxes paid to a foreign country by citizens or alien residents of the United States were not allowable deductions. The provisions of the law for the deduction of taxes applied only to taxes paid to the United States, or to some state or political subdivision thereof in the United States. It was evidently an oversight on the part of the framers of the law. In his report of December 6, 1915, the Commissioner of Internal Revenue recommended that foreign taxes be made allowable deductions, and the permission was granted in the 1916 law. In considering returns prior to 1916, this change in the law must be kept in mind.

1916 LAW (as amended in 1917). Section 5. "That in computing net income in the case of a citizen or resident of the United States—

"(a) For the purpose of the tax there shall be allowed as deductions— . . . .

The foregoing section provides a blanket deduction for *all taxes except*:

1. United States income, war profits and excess profits taxes.
2. A proportionate part of income, war profits and excess profits taxes imposed by a foreign country or possession of the United States. [See section 222 (a-5).]
3. Local improvement taxes.
4. Taxes paid pursuant to a tax-free covenant in corporate obligations. (But such tax may be credited against the total tax payable by the obligee.)
5. Taxes on stockholdings, paid by the corporation without reimbursement from the owners of such stock.

Excess profits taxes may be "credited."—

Law. Section 236. That for the purpose only of the tax imposed by section 230 [income tax rates] there shall be allowed the following credits: . . . .

(c) The amount of any war-profits and excess-profits taxes imposed by Act of Congress for the same taxable year. The credit allowed by this subdivision shall be determined as follows:

(1) In the case of a corporation which makes return for a fiscal year beginning in 1920 and ending in 1921, in computing the income tax as provided in subdivision (a) of section 205, the portion of the war-profits and excess-profits tax computed for the entire period under clause (1) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of

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"Third. Taxes paid within the year imposed by the authority of the United States (except income and excess profits taxes) or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits."

The phrase "except income and excess profits taxes" was inserted in the 1917 law. The provisions of the 1917 law relating to deductions for taxes paid were exactly the same for individuals and for corporations.

1917 Law (excess profits tax credit). Section 29. "That in assessing income tax the net income embraced in the return shall also be credited with the amount of any excess profits tax imposed by Act of Congress and assessed for the same calendar or fiscal year upon the taxpayer and, in the case of a member of a partnership, with his proportionate share of such excess profits tax imposed upon the partnership."

subdivision (a) of section 205, and the portion of the war-profits and excess-profits tax computed for the entire period under clause (2) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (2) of subdivision (a) of section 205.

(2) In the case of a corporation which makes return for a fiscal year beginning in 1921 and ending in 1922, in computing the income tax as provided in subdivision (b) of section 205, the war-profits and excess-profits tax computed under subdvision (b) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivsion (b) of section 205.

The method of calculation of excess profits taxes payable is fully described in *Excess Profits Tax Procedure*, 1921, and the Appendix A of this volume. After a return is prepared showing the taxpayer's net income, the next step is the determination of the amount due as excess profits tax. For the sole purpose of caclulating the amount due as federal income tax, the amount of the excess profits tax (accrued but not paid) may be entered as an allowable deduction. On the remaining balance of net income, the federal income tax is to be assessed (see Chapter VII).

"Net income" is specifically defined in the law. After net income has been ascertained the excess profits tax is "credited" against net income (in fact deducted from "net income") and on the balance the income tax is imposed. It is clear, therefore, that in determining whether or not a corporation is entitled to the specific exemption of $2,000, it is only necessary to consider whether the "net income" is $25,000 or less. The excess profits tax is not considered because it has nothing to do with determining the "net income" of the corporation, which is the limiting factor. It has been suggested that the credit for excess profits taxes applies against the net income, and, if such net income is reduced to less than $25,000, the specific credit can be taken. No justification exists for such an interpretation.

A corporation has a *net income* in 1921 of $27,000. Its excess profits tax is $4,000. Income tax is computed as follows:

Net Income		$27,000.00
Less: Credits:		
Excess profits tax	$4,000.00	
Specific credit (not applicable)	....	4,000.00
Income subject to tax		$23,000.00
Income tax at 10%		$ 2,300.00

The fact that the credit of $4,000 reduces the taxable income to $23,000 does not make such income subject to the specific credit of $2,000. The latter is deductible only when the original *net income* as defined in the law[3] is $25,000 or less.

Foreign taxes paid may be deducted from taxes assessed in United States.—Subject to certain restrictions contained in section 222, quoted below, income or excess profits taxes paid during the taxable year to a foreign country or to any possession of the United States may be deducted from the amount determined to be due to the United States. This does not mean that such taxes are a deduction from or credit against net income, but that the items are a deduction from the amount of *taxes* otherwise payable. The amount to be credited is not to exceed the same proportion of the tax against which credit is taken, which the foreign income is of the total net income [see section 222 (a-5) below].

INDIVIDUALS.—

LAW. Section 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States, the amount of any such taxes paid during the taxable year to any foreign

[3] Section 232.

country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be. . . . .

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits.

(d) If the taxpayer makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or part, any such credit which he finds has already been taken by the taxpayer.

Limitation of credit for taxes paid to foreign governments and possessions of the United States.—

Law. Section 222. (a) . . . . (5) The above credits shall not be allowed in the case of a citizen entitled to the benefits of section 262; and in no other case shall the amount of credit taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources

without the United States bears to his entire net income (computed without such deduction) for the same taxable year. . . .

Section 262 refers to those receiving most of their income from sources within United States possessions. (See Chapter XXXVI.)

A citizen of Canada residing in the United States receives a net income of $40,000, of which $20,000 is net income in Canada and $20,000 is net income in the United States. The Canadian income tax is $1,300. The net income from sources without the United States, not deducting the Canadian income tax, is $20,000. The entire net income from all sources is $40,000. The proportion of the foreign income to the total income is ½. The United States tax is $1,800. The limit for the credit for foreign credit against this tax is, therefore, ½ of $1,800, or $900. Hence, the taxpayer cannot take credit for the full $1,300 paid to the Canadian government, but only for $900 thereof. In other words, the maximum credit deductible is that proportion of the United States tax which the foreign net income bears to the total net income. The maximum, of course, cannot exceed the actual amount of the foreign tax. The $400 of foreign tax not allowed as a credit against United States tax is, however, allowed as a deduction in computing total net income [section 214 (a-3-b); see page 938].

Taxes on foreign dividends.—

Ruling. Where under a foreign income tax law corporations are required to withhold a fixed percentage of the total amount of dividends paid to the stockholders in this country, such tax being withheld in a lump sum, although imposed upon the individual stockholders, the amounts withheld not being itemized by the foreign government, in lieu of the individual tax receipts required to be attached to Form 1116, the taxpayer may attach to the return on Form 1116 his affidavit showing the number of shares held during the year, whether or not any of the shares held by him were acquired or sold during the year, giving dates and number of shares so acquired or sold; the total number of shares outstanding on which the dividend was declared regardless of whether the dividend was paid to citizens of the United States or other governments; and the total dividends paid or accrued on such shares during the year, and attach to and

make a part of such affidavit a certified copy of the tax receipts from the foreign tax collector showing the payment of the tax en bloc, with copies of any other documents which he may have that will serve to corroborate the facts set forth in such affidavit.

The amount of the credit claimed should be computed by dividing the total tax withheld by the total number of shares of the corporation outstanding and multiplying this result by the number of shares held during the entire year. In the event that any of the shares were acquired or disposed of during the year, an adjustment should be made showing the amount of taxes properly allocated to the dividends received after acquisition or before disposition of the stock. (C. B. 1, page 188; O. D. 232.)

COUNTRIES WHICH DO AND DO NOT ALLOW UNITED STATES CITIZENS WHO ARE RESIDENTS A CREDIT FOR THE AMOUNT OF INCOME AND PROFITS TAXES PAID TO THE UNITED STATES.—

REGULATION. (*a*) The following is an incomplete list of the countries which satisfy the similar credit requirement of section 222 (a) (3) of the Revenue Act of 1921, either by allowing to citizens of the United States residing in such countries a credit for the amount of income, war profits, or excess profits taxes paid to the United States, or in imposing such taxes, by exempting from taxation the incomes received from sources within the United States by citizens of the United States residing in such countries: Bulgaria, Canada, Italy, Newfoundland, Salvador. (*b*) The following is an incomplete list of the countries which do not satisfy the similar credit requirement of section 222 (a) (3) of the Revenue Act of 1921, either by allowing no credit to citizens of the United States residing in such countries, for the amount of income, war profits, or excess profits taxes paid to the United States, or because such countries do not impose any income, war profits, or excess profits taxes: Argentina, Bahama, Belgium, Bermuda, Bolivia, Bosnia, Brazil, Chile, China, Costa Rica, Dutch Guiana, Ecuador, Egypt, Finland, France,[1] Great

[1] [Former Procedure] The following special decision has been published affecting taxes paid to France:

RULING. In accordance with section 222 (a) 1 of the Revenue Act of 1918, an American citizen may credit the amount of Federal tax with the amount of any income, war profits, and excess-profits taxes paid during the taxable year to France, provided such tax paid to France is on income from sources therein. If, however, the tax paid to the Government of France is imposed on an amount fixed at seven times the rent of his residence in France (whether because he actually receives no income or insufficient income from France), such tax would be considered not to have been imposed on income from sources therein, and, therefore, not a proper credit under section 222(a) of the Act. The tax would, however, be a proper deduction under section 214 (a) 3. (B. 45-21-1911; O. D. 1093.)

This footnote is continued on next page.

Britain and Ireland, Guatemala, Herzegovina, India, Jamaica, Japan Montenegro, Morocco, New Zealand, Nicaragua, Panama, Paraguay, Persia, Peru, Portugal, Rumania, Santo Domingo, Serbia, Siam, Straits Settlements, Sweden, Switzerland, Venezuela. The former names of certain of these territories are here used for convenience in spite of the actual or possible change in the name or sovereignty. A resident of the United States who is a citizen or subject of any country in the first list is entitled, for the purpose of the total tax due the United States for 1921 (as to fiscal years beginning in 1920, see art. 386) and subsequent years, to a credit for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. If he is a citizen or subject of any country in the second list, he is not entitled to such credit. If he is a citizen or subject of a country which is in neither list, then to secure the desired credit he must prove to the satisfaction of the Commissioner that his country satisfies the similar credit requirement of the statute. (Art. 385.)

Portion of income tax paid to foreign government by citizen or resident of United States not allowed as a credit is an allowable deduction.—The limitation on the deduction of income tax by a citizen-resident of the United States under section 214 (a-3-a) is modified under section 214 (a-3-b) in cases wherein a citizen or resident of the United States is taxed by the authority of a foreign country on income derived from sources entirely within the United States. A citizen of the United States residing abroad in many cases will be taxed by a foreign government on income derived from sources within the United States. The limitation in section 214 (a-3-a) applies only to income and profits taxes paid *to* the United States. Therefore income taxes paid to foreign governments by a citizen or resident of the United States are

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Ruling. Any income, war profits, or excess-profits taxes paid by a citizen of the United States in 1918 to a foreign country, with respect to income received from sources therein, are an allowable credit under section 222 (a) of the Revenue Act of 1918 against the amount of the tax due to the United States for that year, provided the taxpayer's books of account are kept on a cash-receipt and payment basis and a return is rendered on that basis; if the taxpayer's books are kept on an accrual basis, and his returns are so rendered, the credit for taxes paid to a foreign country on income received from sources therein will be limited to taxes accrued in the taxable year for which the return is rendered. (C. B. 2, page 196; O. 987.)

allowable deductions from gross income under section 214 (a-3-b), to the extent that such taxes are not allowed as credits under section 222[5] and, not being imposed by the authority of the United States, do not fall within the inhibition in section 214 (a-3-a).

CORPORATIONS.—

LAW. Section 238. (a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States: *Provided*, That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year. In the case of domestic insurance companies subject to the tax imposed by section 243 or 246, the term "net income," as used in this subdivision means net income as defined in sections 245 and 246, respectively.

The limitation on the credit mentioned above is the same as in the case of citizens or residents. For detailed computation see page 944.

The provisions of the law regarding accrued taxes differing from those paid, information to be furnished, and fiscal years are the same for corporation as for individuals. (See page 953.)

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[5] [Former Procedure] Taxes imposed by a foreign country on income from sources within the United States were *not* credits against the tax due to the United States under the 1918 law. Section 222 (a) (1) of that law specified that to be credits such taxes must have been assessed on "income derived from sources therein."

RULING. Income and war-profits taxes paid to a foreign country by a citizen of the United States residing in such foreign country on income from sources within the United States can not be treated as a credit for taxes under section 222. Such taxes are deductible under section 214 (a) (3) in computing net income in his return to the United States. (C. B. 1, page 188; O. D. 317.)

CREDIT FOR TAXES WHEN DOMESTIC CORPORATION OWNS CONTROL IN FOREIGN SUBSIDIARY.—

LAW. Section 238. . . . . (e)[6] For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided*. That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation.

In order to prevent a domestic corporation securing credit against its United States tax for foreign income and profits taxes paid by a foreign subsidiary in a disproportionate degree, a limitation similar to that imposed upon taxpayers paying

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[6] [Former Procedure] Under the 1918 law [section 240 (c)] the foreign income tax to be allowed as a credit was such tax "paid," not "accrued," within the taxable year. The portion of such tax deductible was based on the ratio of the dividends received from such foreign corporation to its total net income. The limitation imposed was that such credit should not exceed the amount of dividends received from such foreign corporations. For detailed discussion see *Income Tax Procedure,* 1921, pages 752-755.

foreign income taxes directly was included in the 1921 law. This limitation is based on the theory that the foreign tax credited against the United States tax should be at the same rate with respect to foreign income as the United States tax is to United States income. In other words, it was felt that it would not be equitable to allow credit for foreign tax against United States tax if the foreign taxes were imposed at a higher rate than the United States tax. To accomplish this object the foregoing provision of the 1921 law contains a statement of a maximum limit to the credit for foreign tax, viz.: the proportion of United States tax equal to the ratio of dividends received from the foreign corporation to total net income (including such dividends) of the domestic corporation.

To illustrate assume the following: A domestic corporation (A) owns the entire capital stock of a foreign corporation (B):

Net income of A	$100,000 (a)
United States income and profits taxes payable by A	$ 10,500
Net income of B	$ 20,000
Foreign income and profits tax payable by B	4,000
Balance of accumulated profits available for dividends	$ 16,000 (b)
Dividend paid by B to A	$ 10,000 (c)

Ratio of (c) to (b) = 5/8 (d)
Ratio of (c) to (a) = 1/10 (e)

The foregoing ratios are used in determining whether the limitation of tax indicated by (e) will preclude the full allowance indicated by (d).

Foreign taxes paid "with respect to the accumulated profits" of $16,000, i. e., $4,000.	
⅝ (see above) thereof = foreign taxes allocated to dividend paid to United States parent corporation	$2,500
But credit must not exceed 1/10 of United States tax ($10,500)	1,050
Amount of foreign tax disallowed as a credit	1,450

It would seem, therefore, that the United States tax payable by the domestic corporation would be $9,450 ($10,500 — $1,050). In other words, the limitation applies.

Section 238 (e) states that the ratio for the limitation is the "proportion . . . . which the amount of such dividends bears to the amount of the entire net income of the domestic corporation." The theory is that the United States corporation will be allowed as a credit against the United States tax the foreign tax paid with respect to the dividend from the foreign corporation included in the United States corporation's income, which has been subjected to United States tax. By limiting the credit, however, to a proportionate part of the "taxes, against which such credit is taken," the foreign tax is, in effect, reduced to the same rate as the United States tax on the foreign dividend. If the rate of tax imposed by the foreign country is higher than the United States rate, the effect of the computation is to allow the credit at the lower United States rate. If, on the other hand, the rate of foreign tax is lower than the United States rate, the full amount of foreign tax would be allowed with respect to such foreign dividend.

It has been suggested that the phrase in section 238 (e) "upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid," might limit the credit for taxes as shown in the above illustration to an amount allocated to the $16,000 of profits remaining after deduction of the foreign tax of $4,000. Such an interpretation of the law, however, is not warranted because the entire amount of foreign tax was paid by the foreign subsidiary in respect of the profits remaining available as dividends.

It is important also to note the difference in treatment of the deduction from United States income of any part of the foreign tax disallowed as a credit. A United States corporation with a foreign branch (unincorporated) is permitted to deduct such an amount as section 234 (a-3) provides for the deduction of "Taxes paid or accrued within the taxable year except . . . . (b) so much of the income, war profits and excess profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, ..." But a United States cor-

poration conducting its foreign business through a foreign subsidiary is not allowed as a deduction from its United States income any foreign tax paid by the foreign subsidiary which is disallowed as a credit against the United States tax of the domestic corporation.

The reason for this is that the deduction for taxes paid, under section 234 (a) quoted above, is allowed only to the taxpayer paying such taxes. In the case of a foreign subsidiary the foreign tax is paid by such foreign corporation and not by the United States corporation.

Regulation. . . . . A domestic corporation seeking such credit must comply with those provisions of subdivision (a) of article 383 which are applicable to credits for taxes already paid, except that in accordance with article 611 the form to be used is Form 1118 instead of Form 1116.[7]

For the purposes of section 238 a corporation entitled to the benefits of section 262 is treated as a foreign corporation. (Art. 612.)

Meaning of terms.—

Regulation. "Amount of . . . . taxes paid during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the individual claiming credit. "Foreign country" includes within its meaning any foreign sovereign state or self-governing colony (for example, the Dominion of Canada), but does not include a foreign municipality (for example, Montreal) unless itself a sovereign State (for example, Hamburg). "Any possession of the

[7] [Former Procedure] For procedure as to foreign taxes prior to 1916, see footnote, page 939.

Ruling. A domestic corporation owning a majority of the voting stock of a foreign corporation is not entitled to credit for taxes paid by such foreign corporation to any foreign country or possession of the United States which are not actually paid within the taxable year of the domestic corporation. (C. B. 1, page 237; T. B. R. 36.)

Space does not permit comment on the foregoing ruling. It may be entirely sound; but the author is not convinced by the arguments in the detailed ruling that Congress intended to allow credits for such taxes ("many foreign taxes which accrued prior to 1918 remain unpaid") paid in 1918 and in subsequent years, although they accrued prior to 1918.

United States" includes, among others, Porto Rico, the Philippines and the Virgin Islands. . . . . (Art. 382.)

The definition in the foregoing regulation of the phrase "to any foreign country," is no doubt technically correct, but it probably does not carry out the intention of Congress. In the first edition of Regulations 45 the term used was, "any governmental authority,"[8] which more nearly accords with the accepted meaning of "any foreign country." The Treasury has not been consistent in its definitions of "foreign government" and "foreign country." The section of the law setting forth the items not included in gross income reads:

Law. Section 213. **That for the purposes of this title . . . . the term "gross income"—**

(b) Does not include . . . .

(5) The income of foreign governments received from investments in the United States. . . . .

Article 86 reads as follows:

Regulation. The exemption of income of foreign governments applies also to their political subdivisions. . . . . (Art. 86.)

There is no sound reason why "foreign government" in section 213 should be construed to include political subdivisions, whereas the term "foreign country" used in sections 222 and 238 is construed to exclude such subdivisions.

It is customary to refer to "state" income taxes and it is quite conceivable that in a federal statute state income taxes might be specifically mentioned as being deductible. But if subsequently the city of New York were to impose an income tax and a taxpayer who had been paying $1,000 to the state thereafter paid $500 to the state and $500 to the city the courts would probably hold that since a city is an instrumentality of a state, income taxes paid to a city would be deductible.

If a citizen of the United States who now pays a $1,000

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[8] **[Former Procedure]**

Regulation. " . . . . Foreign country" means any governmental authority, not that of the United States or any part or possession thereof, having power to impose such taxes, and it therefore includes a self-governing colony, such as the Dominion of Canada. . . . . (Reg. 45, April, 1919, Art. 382.)

income tax in England hereafter should pay $500 direct to the British government and $500 to the city of London the regulation would prohibit the deduction of the amount paid to London, even though the change merely represented an adjustment of a policy of apportionment.

In the opinion of the author the words "to any foreign country" mean "to any foreign country or any subdivision of a foreign country which has or may receive authority to impose an income tax."

The intention of the law was to reduce the burden on a citizen of the United States who might be taxed very heavily on income arising in a foreign country. It would seem to make little or no difference whether such foreign tax were imposed by a municipality or by a recognized sovereign government.

In one country the state might impose income taxes. In another country with a different tax system, income taxes equally onerous might be laid by local authorities but none by the state. Congress did not intend to discriminate against one system in favor of the other.

The following decision has recently been issued:

RULING. The term "foreign country" as used in sections 238 (a) and 234 (a) (3) of the Revenue Act of 1918 is held to mean the composite whole made up of all the subdivisions of a foreign State subject to the same central control. Each of the subdivisions, in this sense, is not a "country" but a part of a "country." The Province of British Columbia, therefore, does not come within the meaning of the term "foreign country" as contemplated by the statute.

Amounts of mineral tax and income tax paid or accrued to the Province of British Columbia by a domestic corporation are deductible as business expenses from the taxable income of the corporation. (B. 39-21-1844; O. D. 1050.)

PROCEDURE FOR SECURING CREDIT FOR FOREIGN TAXES.—

REGULATION. (*a*) When credit is sought for income, war profits or excess profits taxes paid other than to the United States, the income tax return of the individual must be accompanied by Form 1116, carefully filled in with all the information there called for and with the calculations of credits there indicated, and duly signed

and sworn to or affirmed. When credit is sought for taxes already paid the form must have attached to it the receipt for each such tax payment. When credit is sought for taxes accrued the form must have attached to it the return on which each such accrued tax was based. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original or a duly certified or authenticated copy. (b) In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to Form 1116. If such a bond is required, Form 1117 shall be used for it. It shall be in such penal sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, his agent or representative, as principal, and by sureties satisfactory to and approved by the Commissioner. . . . . (Art. 383.)

Form 1116 provides for the calculation of such tax in terms of foreign money and its conversion into United States money, but does not state what rate of exchange is to be used. The form does specify, however, that claimant must "attach a statement describing in reasonable detail why and how he determined upon this particular rate."

The Treasury has ruled[9] in the case of income credited that the rate of exchange prevailing at the time the amounts were credited should be used. This is of importance in these days of highly variable exchange rates. It therefore seems proper to use the prevailing exchange rate on the date or dates when taxes were actually paid to the foreign countries.

Credit for foreign taxes under fiscal year basis.[10]—In case of fiscal years 1920 to 1921, the credit is computed

[9] Letter to Herbert M. Teets, New York, N. Y., signed by Deputy Commissioner L. F. Speer, dated January 11, 1916; also C. B. 3, page 234; O. D. 809.

[10] **[Former Procedure]**

Ruling. A domestic corporation which derives its entire income from operations in Cuba and keeps its books on an accrual basis, may file on Form 1118 a "claim for credit" of the amount of any Cuban income, war

for the full year under the 1921 law, and the portion thereof not already claimed is allowed [section 238 (d)].

When amounts subsequently paid differ from accruals.—

Regulations. In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited against any income, war profits or excess profits taxes, or instalment thereof, then due from such taxpayer under any other return, and any balance of such amount shall be immediately refunded to him. . . . . (Art. 384.)

. . . . To secure such a credit a domestic corporation must pursue the same course as that prescribed for an individual by article 383, except that form 1118 is to be used for claiming credit and form 1119[11] for the bond, if a bond be required. For the redetermination of the tax, when a credit for such taxes has been rendered incorrect by later developments, see article 384, all of the provisions of which apply with equal force to a corporation taxpayer. For credit where taxes are paid by a foreign corporation controlled by a domestic corporation, see article 612. A claim for credit in such a case is also to be made on form 1118. (Art. 611.)

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profits or excess profits tax accrued for the fiscal year ended June 30, 1918, and apply such credit against its Federal income and profits tax for the same fiscal period. This credit should be prorated with reference to that part of the fiscal year falling within the calendar year 1918. If the 1918 Federal tax has been paid without claiming this credit and the company wishes to credit the overpayment against the 1919 taxes, Form 1118 should be accompanied by a claim for refund on Form 46 and possibly a claim for credit on Form 47-A.

A claim for credit on Form 1118 for the amount of Cuban income, war profits or excess profits tax accrued for the fiscal year ended June 30, 1919, may be filed and applied against the company's Federal tax liability for the same fiscal period. (C. B. 2, page 221; O. D. 406.)

See also section 238 (c), 1918 law.

[11] See Appendix of *Excess Profits Tax Procedure*, 1921, for reproduction of form.

Forms to be used by individuals and partnerships when credit for foreign taxes is claimed.—

Ruling. A domestic partnership has leased certain of its patents to a British licensee for a fixed royalty, and the British government requires the licensee to withhold and pay to it the British income tax on the royalty payments.

The partners, in order to obtain credit for such tax paid to the British Government, should attach to the return of the firm on Form 1065 a claim for credit, Form 1118, modified throughout by substituting the word "partnership" for the word "corporation." In lieu of the required receipt or return, a copy of the receipt issued to the British licensee showing the payment of tax made to the British Government, duly attested by the president of the British licensee, will be accepted. The individual members of the partnership are required to attach Form 1116 to their individual returns, accompanied by a copy of the receipt issued to the British licensee and a copy of the affidavit made by the president of the British licensee. (C. B. 3, page 220; O. D. 583.)

When a partnership pays income or excess profits taxes to a foreign country the tax so paid is not to be included as an expense in form 1065,[12] but is to be allocated to the individual partners on the same basis as the profits. The amounts may, subject to the limitations already mentioned, be deducted by the partners from the *tax* computed on their individual returns. Only the difference, if any, between the foreign tax so credited and the total amount of such foreign tax, is to be entered in form 1065 and thus be deducted from gross income in computing net income subject to United States income tax.

Massachusetts trust operating property in a foreign country.—Where, under the laws of a foreign country, taxpayers are taxed as individuals, although in this country they would be and are regarded as an association, the individuals who were actually assessed by the foreign government must claim credits against their individual income taxes, and the association not having paid the tax cannot claim the credit.

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[12] For copy of form, see Appendix B.

Ruling. A Massachusetts trust, taxable as an association, owns and operates property in a foreign country, which does not recognize the separate entity of the association but regards it as a partnership, the shareholders paying income tax individually to the foreign country upon their respective shares of the net profits of the association.

Held, that the association is not entitled to claim under the Revenue Act of 1918, as a credit on Form 1116, the amount of the taxes so paid by the shareholder, but that the shareholders who paid such taxes are entitled to the credit within the limitation of article 381, Regulations 45. (B. 42-21-1872; A. R. R. 643.)

Tax on bank stock, etc., no longer deductible by shareholders.—Taxes on bank stock (or similar taxes on the stock of other corporations) paid by the bank are, under the 1921 law, deductible by the bank, but they are not deductible by the shareholders.[13]

Regulations. Under the revenue act of 1921 banks or other corporations paying taxes assessed against their stockholders on account of their ownership of the shares of stock issued by such corporations, without reimbursement from any such shareholder or member, may deduct the amount of taxes so paid. The statute specifically provides, however, that in such cases the stockholders may not deduct the amount of the taxes.[14] (Art. 566.)

In computing the net income of an individual no deduction is allowed for the taxes imposed upon his interest as shareholder or member of a bank or other corporation, which are paid by the corporation without reimbursement from the taxpayer. . . . . (Art. 135.)

Taxes paid under secured debt laws deductible.—

Regulation. . . . . Amounts paid to States under secured debts laws in order to render securities tax exempt are deductible. (Art. 131.)

Automobile license fees deductible.—

Regulation. Automobile license fees are ordinarily taxes. (Art. 131.)

Ruling. A taxpayer whose books are kept on the receipts and disbursements basis may deduct from gross income on his 1919 return

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[13] See page 734 for procedure under the 1913 law. See *Income Tax Procedure,* 1921. Under the 1918 law, stockholders for whom a corporation paid taxes assessed on their holdings, were required to report such taxes as additional dividend, subject to surtax, at the same time deducting the item under "taxes" in computing net income. But see *Income Tax Procedure,* 1921, page 760 *et seq.*, rulings under 1918 law.

[14] Section 214 (a-3).

automobile taxes levied against him by the State of Iowa for 1919 and 1920, provided he actually paid such taxes during 1919. If the books of the taxpayer are kept on the accrual basis, then only the amount of such tax applicable to the year 1919 may be taken as a deduction in preparing his 1919 income tax return, and the amount which represents the 1920 tax may be deducted on such taxpayer's 1920 return, notwithstanding the fact that he actually paid the tax for both years in 1919. (C. B. 2, page 116; O. D. 388.)

Business, excise and license taxes deductible.—

Regulation. . . . . business, license, privilege, excise . . . . taxes paid to internal revenue collectors, are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted. (Art. 132.)

The foregoing regulation does not operate as a limitation upon the deduction, but merely points out that a dealer who pays these federal taxes must not deduct them twice.

The stipulation that the taxes be paid to an internal revenue collector must be regarded as explanatory. It must not be interpreted to mean that taxes to be deductible must be paid to an internal revenue collector. It simply means that taxes so paid are among the allowable deductions.

All taxes other than federal income and profits taxes and local assessments, are deductible by the taxpayer who is assessed for them and responsible for their payment. The actual payments may be made by withholding agents as in the case of theater tickets, etc.

When the tax is paid to the collector by someone other than the taxpayer, the latter is the only one who can claim the payment as a deduction.

Rulings. The Republic of Cuba imposes on all corporations operating sugar plantations in Cuba, a tax of a certain amount on each bag of sugar produced. Apparently this tax is based on production, not on income, and is in the nature of an excise tax. Therefore a domestic corporation may deduct from gross income in its return to the United States Government the amount of such tax paid to the Cuban Government but may not claim the amount as a credit

against the total tax due to the United States. (C. B. 2, page 115; O. D. 372.)

Wholesale liquor dealers who exercised their option of including excise taxes in cost of merchandise in calculating inventory may not now amend such inventory and treat the taxes as business expenses. (C. B. 1, page 112; O. D. 137.)

Excise and stamp taxes are deductible only by the one against whom such taxes are levied.—

Ruling. Receipt is acknowledged of your letter of February 28, 1920, in which you inquire as to the taxpayer who is entitled to the benefit of a deduction from gross income in respect of excise and stamp taxes levied by the federal government.

In reply you are advised that the general rule which applies in respect of a deduction for all taxes is that the deduction may be taken only by the person against whom such taxes are levied. The fact that one person ultimately pays a tax levied upon another does not give such person a right to the benefit of the deduction.

As to the person against whom excise and stamp taxes are levied, your attention is directed to sections 900 to 907, and 1006, 1100 to 1107, inclusive, of the Revenue Act of 1918. (Letter to Leslie, Banks & Company, New York, N. Y., signed by G. V. Newton, Acting Assistant to the Commissioner, and dated March 6, 1920.)

Customs duties deductible.—

Regulation. Import or tariff duties paid to the proper customs officers . . . . are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted. (Art. 132.)

The deduction may be claimed on articles intended for personal or family use as well as by dealers who buy to resell.

Stamp and similar taxes deductible.—

Regulation. . . . . stamp taxes paid to internal revenue collectors are deductible. . . . . (Art 132.)

In view of the heavy stamp and other taxes being collected by federal and state authorities, it may be worth while for taxpayers to preserve a record of the stamps used on stock transactions and for many other purposes. The payment of taxes

as represented by stamp purchases is plainly an allowable deduction. Stamp taxes on certificates of stock which have been sold should be treated as taxes and not as a deduction from the proceeds of sale.[15] Taxes payable by the manufacturer are not deductible by the ultimate consumer.

Luxury and excise taxes.—The 1921 law has repealed many of the luxury and excise taxes[16] and those that remain are almost all payable by the manufacturer. In view of this it has been decided to omit from this edition of *Income Tax Procedure* any lengthy discussion on this subject such as appeared in the editions of prior years. Although the number of taxes is still large, the test for their deductibility or otherwise is the same in all cases, viz.: Is the tax levied against the person desiring to make the deduction? If, as in the case of club dues or admissions, the tax is levied against the taxpayer, the latter can deduct it. If it is levied against the manufacturer, he includes it in his cost of production and the consumer is not entitled to any deduction; even if the manufacturer passes the tax on to the consumer as a specific item, the consumer cannot deduct it.

Claims where accurate records of tax payments not kept.—Each taxpayer is expected to return every dollar of taxable

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[15] **[Former Procedure]** Under the 1918 law taxable income was the same whether tax stamps were treated as expenses or as taxes, but under the 1913 law and in most cases under the 1917 law stock losses were not deductible. Hence when stamp taxes on transfers of stock were treated as deductions from proceeds of sales (and the transaction resulted in a loss), credit was not secured for the item of stamp taxes, because the cost of the stamps was merged in the stock loss.

[16] **[Former Procedure]** Under the 1917 law taxes were imposed on a large variety of things including the following: facilities (passenger fares, freight, express, berths, seats, telegraph and telephone messages), promissory notes (except when Liberty bonds were used as collateral) conveyances of real estate, powers of attorney, proxies, admissions to theaters and other places of amusement, and dues charged by social and similar clubs.

The 1918 law modified these taxes to some degree and added the luxury tax, the tax on the retail price of jewelry, perfumes, cosmetics, etc. In addition, there were levies against a greatly extended list of articles payable by the producer on the basis of the wholesale price rather than by the consumer on the basis of the retail price.

income even though no permanent record of it was made. Similarly a taxpayer may claim credit for all taxes paid if the claim is made in good faith and can reasonably be supported. Since receipts were not usually given by those who collected the taxes, vouchers cannot be furnished. If one's memory is trustworthy no objection can be made to a claim based on the taxpayer's statement.

Ruling. An individual may claim as a deduction the amount of war tax paid on facilities furnished by public utilities, which include tax on railroad and steamship fares, and the war tax paid on admissions and dues. The war excise taxes imposed by section 904 and paid by the purchaser are deductible, but the war excise taxes imposed by section 900, which are levied against and paid by the manufacturer, producer, or importer, are not deductible by the individual purchaser. (C. B. 1, page 112; O. D. 287.)

Inheritance taxes deductible.—On June 6, 1921, the United States Supreme Court held[17] that when Congress included all taxes[18] among allowable deductions it used language which is to be taken in its ordinary meaning, and that inheritance or estate taxes paid by an estate may be deducted from taxable income.

Decision. The act of 1916 calls the estate tax a "tax" and particularly denominates it an "estate tax." This court recently has recognized that it is a duty or excise and is imposed in the exertion of the taxing power of the United States. *New York Trust Co.* v. *Eisner,* — U. S. —. It is made a charge on the estate and is to be paid out of it by the administrator or executor substantially as other taxes and charges are paid. It becomes due not at the time of the decedent's death, as suggested by counsel for the Government, but one year thereafter, as the statute plainly provides. It does not segregate any part of the estate from the rest and keep it from passing to the administrator or executor for purposes of administration, as counsel contend, but is made a general charge on the gross estate and is to be paid in money out of any available funds or, if there be none, by converting other property into money for the purpose.

[17] *U. S. v. Alan H. Woodward, et al.,* (T. D. 3195; C. B. 4, page 153).
[18] The suit was brought under the 1916 law under which federal income as well as all other taxes (except those for local benefits) were allowable deductions. Under later laws the only exclusions are federal income and profits taxes.

The author consistently held in all former editions of this book that, unless and until the law restricts the deductions of inheritance or estate taxes, the amount paid by, or for, an estate is an allowable deduction.

Regulation. Federal estate taxes, paid or accrued during the taxable year, are an allowable deduction from the gross income of the estate in computing the net income thereof subject to tax. Such taxes are deemed to have accrued on the due date thereof, namely, one year after the decedent's death, except in any case where the Commissioner has granted an extension or extensions of time for payment, such taxes are then deemed to have accrued on the due date or dates of such extension or extensions.

Estate, succession, legacy, or inheritance taxes, imposed by any State, Territory or possession of the United States, or foreign country, are deductible by the estate, subject to the provisions of section 214, where, by the laws of the jurisdiction exacting them, they are imposed upon the right or privilege to transmit rather than upon the right or privilege of the heir, devisee, legatee, or distributee, to receive or to succeed to the property of the decedent passing to him. Where such taxes are imposed upon the right or privilege of the heir, devisee, legatee, or distributee, so to receive or to succeed to the property, they constitute, subject to the provisions of section 214, an allowable deduction from his gross income.

Where, in accordance with a direction contained in the testator's will, the taxes upon the right to receive any particular devise or devises, legacy or legacies are so payable as to relieve the particular devisee or devisees, legatee or legatees from the burden thereof, then the person or persons entitled to the fund or other property out of which payment is made may not take deduction of the taxes so paid, but deduction thereof is available only by such devisee or devisees, legatee or legatees; each, if there be more than one, being authorized to deduct such part of the taxes so paid as he would otherwise have been entitled to do had there been no such testamentary direction.

Where there is a life estate and a remainder, and, by the laws of the jurisdiction imposing them, the taxes in respect to both interests are payable out of the remainder interest, with no legal obligation imposed whereby the remainderman is entitled to reimbursement, then deduction of the taxes so paid may be taken only by the remainderman. Where, in the case of an annuity, the taxes in respect thereto are, by the laws of the jurisdiction imposing them, payable in the first instance out of the fund set aside for creating the annuity, but are to be repaid or restored to such fund from the annuity, then deduction thereof may be taken only by the annuitant.

The accrual dates of such taxes shall be the due date thereof ex-

cept as otherwise provided by the law of the jurisdiction imposing them. Where deduction is claimed of any such taxes, the amount thereof and the name of the State, Territory, or possession of the United States, or foreign country, by which they have been imposed shall be stated in the return. (Art. 134.)

The foregoing regulations recognize that taxes accrued as well as paid may be deducted. The deduction for accrued taxes is not limited to estates which keep their accounts on an accrual basis, because the law [section 214 (a-3)] provides that the allowable deduction is for taxes paid *or* accrued, and specifies that estate taxes accrue "on the due date thereof."

The regulation points out the conditions under which the right to deduct inures to the estate and when to the distributees. For instance, when legacies are made payable free of tax, and the estate pays the tax for the legatee, it is held that the latter and not the estate is entitled to the deduction. The same principle is applied to remaindermen and annuitants. The deduction is complicated by the procedure in the local jurisdiction in which the estate is administered. It may be expected, therefore, that the foregoing regulations will be amended from time to time.

Taxes paid for another person—who deducts?—Credit should be taken for taxes by the owner of the property taxed; but if a husband pays the taxes on a residence the title to which is in the name of his wife there appears to be no prohibition in the law against the deduction by the husband in his return. Strictly speaking, the payment represents a gift to the wife and should be deducted by her.

Tax deductions too broad.—In the opinion of the author not all taxes deductible under the law are proper deductions. For example, a tax paid upon an individual's own residence, the rental value of which is not taxable, is an allowable deduction, although such a tax clearly is a living or personal expense. This may be said to be true also of luxury taxes and of import duties paid by individuals on goods destined for

their personal consumption. It would be more equitable if taxes were deductible only when paid on income-producing property or on property acquired for income-producing purposes.

Taxes Not Deductible

The law permits the deduction from gross income of all taxes levied by the authorities enumerated, with four specific exceptions, viz., the federal income tax, the excess profits tax,[19] a proportionate part of foreign income and excess profits taxes (which are a credit against United States taxes), and certain types of special assessments. Consequently the procedure at this point resolves itself largely into the problem of determining whether or not particular expenditures are taxes.

Federal income tax cannot be deducted.—In 1917 the practice of permitting the deduction of federal income taxes was abandoned.[20] They are no longer deductible.

In the period of low rates the question of deducting the

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[19] The excess profits tax is credited against net income in computing the income tax.

[20] [Former Procedure]

Deductibility of 1916 income taxes accrued on portion of fiscal year ending in 1917.—Federal income taxes were deductible before 1917. The law forbidding the deduction was passed October 3, 1917. It was the intention of Congress to apply the restriction to the new income and excess profits taxes, and the restriction was a perfectly sound one, but there was no intention to forbid a taxpayer to take credit for accrued 1916 federal income taxes. For comments and suggestion, see *Income Tax Procedure,* 1920, pages 614-615.

Ruling. Additional excise taxes assessed against a corporation under the Revenue Act of 1909 and paid during subsequent years are allowable deductions from the gross income reported on the corporation's return for the year in which paid; but income taxes assessed under the Revenue Acts of 1913 or 1916 are deductible only if paid prior to January 1, 1917. (C. B. 1, page 111; O. D. 240.)

The foregoing ruling is erroneous. T. D. 2433 (January 8, 1917) permitted the deductions of 1916 taxes accrued December 31, 1916, but not paid. The regulation has not been rescinded, but in specific cases individuals as well as corporations have been permitted to make the deduction.

income tax was of slight practical importance, but when rates rose to a level where, in some cases, they took the bulk of the taxpayer's income, the situation was entirely changed. It may appear at first glance that the allowance or prohibition of the deduction would make no net financial difference to the government, because it could raise the rates to compensate for the decrease in the aggregate tax base. But as a matter of fact the allowance of this deduction would cut in half the total possible financial productivity of the income tax. Approaching the question from the point of view, not of the aggregate yield, but of the distribution of the burden among the taxpayers—the individual point of view—it will readily be seen that, under highly progressive rates, the allowance of the deduction would have the effect of providing relief to those in the upper surtax classes to a much greater extent both absolutely and relatively than to those in the lower classes. It would operate "to flatten out" the progressive rates. Again, during a period when incomes are fluctuating violently in amount from year to year and when the tax rates themselves change with the seasons, the permission to deduct income tax payments would yield very uneven results.[21]

Finally the argument that to refuse the deductions is to levy a tax on a tax is specious. The government is seeking a standard by which to apportion a burden and it decides that this apportionment shall be according to net incomes as they stand before the burden is imposed—not according to the amounts remaining after provision has been made for the burden which it is seeking to impose. There should be no objection on the part of the taxpayers to this provision in the law.

[21] Assume two men with equal incomes in 1919, one of whom in 1918 had the same income as in 1919, while the other that year had no income at all. In 1919, the first man would be taxed much less than the second because of the deduction for income taxes on his previous year's income. On the other hand in 1920, if we assume the incomes of both to remain as they were in 1919, the second man would pay less than the first man because of his heavier 1919 taxes. No matter how long the two might continue to receive the same income, they would never pay the same tax. With rates varying from year to year, the possibilities of inequality would be great.

Adjustment of taxes of prior years.—When there is an adjustment of returns for years prior to 1917 and the income tax is redetermined, the additional tax paid or the refund received may require a further adjustment of taxes for the *succeeding* year or years.

Penalty additions to taxes may or may not be deductible.—

Ruling. (a) The addition to tax authorized to be assessed by section 3176, Revised Statutes, as amended, on delinquent or false and fraudulent returns is to be considered a penalty and not a tax except for purposes of collection.

(b) Such an addition to tax made on excess profits tax returns is not an allowable credit in arriving at the net income subject to normal income tax.

(c) The payment of such an addition to tax is not to be disallowed as a deduction from gross income in obtaining net income on the ground that it is a part of the income or profits tax within the provisions of law forbidding the deduction from gross income of those taxes.

(d) The payment of an addition to tax for delinquency in filing a return may be deducted from gross income as a business expense when such an addition to tax is an incident to carrying on a business or trade. The payment of an addition to tax upon a false or fraudulent return may not ordinarily be deducted from gross income as a business expense and may never be deducted in the case of an individual who himself was guilty of making a fraudulent return. (C. B. 1, page 241; O. 926.)

Special assessments may or may not be deductible.—Taxes which may not be deducted include "those assessed against local benefits of a kind tending to increase the value of the property assessed."[22] The provision which broadens the deduction so as to include assessments which do not increase the value of the property appeared for the first time in the 1918 law and is an improvement over former procedure.[23]

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[22] Section 214 (a-3-c).

[23] **[Former Procedure]** The 1918 law was the same in this respect as the present law. The laws of 1917 and of prior years excluded as deductions all taxes assessed against local benefits. [See 1917 law, section 5 (a), third.]

Regulation. So-called "taxes," more properly assessments, paid for local benefits, such as street, sidewalk, and other like assessments, imposed

Regulation. So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to the property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and when it is clear that the assessments are so limited, the amounts paid thereunder are not deductible as taxes. When assessments are made for the purpose of maintenance or repair of local benefits, the taxpayer may deduct the assessments paid as an expense incurred in business, if the payment of such assessments is necessary to the conduct of his business. When the assessments are made for the purpose of constructing local benefits, the payments by the taxpayer are in the nature of capital expenditures and are not deductible. Where assessments are made for the purpose of both construction and maintenance or repairs, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation can not be made, none of the amounts so paid is deductible. (Art. 133.)[24]

The regulation recognizes the distinction between capital expenditures and expense as constituting the dividing line between the deductible and the non-deductible types of special

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because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. Taxes deductible are those levied for the public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction.

Special assessments, such as are hereinbefore contemplated and which are measured upon the basis of the benefit flowing directly to the property, are not deductible, even though an incidental benefit may inure to the public welfare. (Reg. 33, 1918, Art. 194.)

[24] **[Former Procedure]** The editions of Regulations 45 published early in 1919 included the following sentence: "Assessments under Illinois laws relating to drainage districts are not limited to the property benefited and assessments so paid are deductible." The expression, in the sentence which discusses the statutes of several states, "and when it is clear that the assessments are so limited," was introduced by T. D. 2937. See C. B. 1, page 112; O. D. 928.

assessments. But it also goes further and attempts to apply another test of deductibility, that is, whether an assessment which is not of the nature of a capital expenditure "is necessary to the conduct of his business." The regulation does not directly state that such assessments when imposed against non-business property are not allowable deductions, but it plainly infers this. Whatever can be said for its equity, such a position is obviously illegal. The law itself when it says "Taxes paid . . . . not including those assessed against local benefits . . . ." [section 214 (a-3)] practically defines a special assessment as a tax, and when such assessments are not "of a kind tending to increase the value of the property assessed" they are deductible, irrespective of whether they can be shown to be business expenses or not. The tax on a taxpayer's residence has always been an allowable deduction. Under the 1918 law taxes assessed against local benefits which do not increase the value of the property were also made allowable deductions, and the 1921 law is like that of 1918 in this respect.

Assessments which do not increase value of property are deductible.—There is a legal and economic distinction of long standing between taxes and special assessments. This distinction is based upon the fact that the special assessments ordinarily represent the purchase price of equipping the land with facilities, commonly called "improvements"—such as street paving, side-walks, sewers, etc. This equipment normally results in a "benefit inuring directly to the property against which the assessment is levied." The economic basis for the non-allowance of such assessments consists of the fact that they are in effect expenditures of a capital nature. But it must be recognized that this foundation disappears when the special assessments are levied for purposes transitory in character. Moreover, the use of special assessments for transitory "service" activities—such as lighting and cleaning streets, snow removal, etc.—is becoming more and more wide-

spread. These are essentially expenses and they become allowable deductions under the 1918 law.

Types of special assessments which can be deducted will be found in Massachusetts, where special assessments may be levied to provide funds for street sprinkling, for protection of trees by moth extermination and for current expenses.

Of course, the element of depreciation appears in most public works, but the distinction to be made is whether or not the improvement is one which is properly of a capital nature. If not, the taxes paid on assessments are deductible.

If the improvement is of a capital nature which in time requires renewals, depreciation may possibly be claimed.

Special assessments which may not be deducted.—In the case of the permanent types of equipment, such as sewers, streets, etc., the justice of placing special assessments on a different basis from taxes depends upon whether their nature as capital expenditures is recognized. Theoretically, the buyer of a tract of land makes his purchase "on notice" that he will be called upon to pay for its equipment with sewers, roads, etc., by the special assessment method, and consequently he makes an allowance in the price he pays for the land for this additional expenditure which must ultimately be made up from the prices he will receive when he sells the lots. It is clear that he should be permitted to include all such expenditures for special assessments as capital in calculating his taxable gain for income tax purposes when he has sold his lots. Unless he fully calculated his future special assessment burden when he purchased the tract he will suffer a loss. The same principle applies to special assessments on improved property.

If there is no element "tending to increase the value of the property" the payment does not constitute a proper capital item, because the property owner would not expect to be able to add the assessment to the price of the property in case of sale.

If the assessment does tend to increase the value of the property it is not a deduction for income tax purposes, but it adds to the capital value of the property and should be so regarded in computing the gain or loss in case of sale.

RULING. Amounts expended by an estate on account of special assessments for the maintenance or repair of streets or for sidewalk improvements levied upon property used in a trade or business, if the same is necessary in the conduct of such trade or business, constitute allowable deductions.

In case any of the property of the estate is used for residential purposes by anyone beneficially interested in the estate, the amounts expended in payment of assessments levied upon such property for maintenance and repairs can not be deducted by the estate unless the rental value of the property is included in the gross income of the estate. . . . . (C. B. 3, page 149; O. D. 613.)

As stated on page 968, the author is of the opinion that taxes assessed for local benefits which do not increase the value of the property assessed are deductible.

RULING. Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income. The amount so received by the landlord is taxable income to him but because of its nature is not an allowable deduction from his gross income. (C. B. 2, page 123; O. D. 373.)

CERTAIN SO-CALLED TAXES DEDUCTIBLE ONLY AS BUSINESS EXPENSE.—In some places charges for water furnished by a municipality are known as taxes, chiefly because they are assessed by the city and become a lien on real estate if not paid. Likewise, in certain communities[25] "assessments" are laid upon residents to raise funds for fire protection, road improvement, etc. These do not bear the stamp of government action; they do not become a lien on real estate when not paid; and they are in fact voluntary purchases of certain services and equipment through a common fund. No such expenditures are deductible as taxes or as expenses except when paid as an inci-

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[25] For definition of "political subdivision," see page 951. The definition is of importance when considering items of doubtful deductibility.

dent to the possession of income-producing property or to a business carried on for profit.

Tax on undistributed surplus not deductible.—

Ruling. Replying to your comunication of March 14, 1919, you are informed that the 10 per cent tax which was imposed on corporation's undistributed net income by section 10 (b) of the Revenue Act of September 8, 1916, as amended by the Revenue Act of October 3, 1917, is not an allowable deduction from the gross income of a corporation shown on an income tax return. (Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated April 1, 1919.)

The 10 per cent tax was a tax upon income and for that reason was not deductible.

Postage not deductible as a tax.—

Regulation. . . . . Postage is not a tax . . . . (Art. 131.)

Postage, of course, is deductible as a necessary business expense.

Federal tax paid by corporations under tax-free covenants not deductible.—The 2 per cent federal tax on "tax-free" bonds, which corporations theoretically withhold at the source, is held to be paid for account of the recipient of the interest,[26] and since it is an allowable credit to the recipient, taxes so paid are not deductible by the corporation. In *Notes on the Revenue Act of* 1918, the Secretary of the Treasury suggested (page 22) that the law be amended to provide that "such tax may be deducted by the obligor as interest."

Regulation. Corporations may deduct taxes from gross income to the same extent as individuals, except that in the case of corporate bonds or obligations containing a tax-free covenant clause, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from gross income on any ground. In the case, however, of corporate bonds or obligations containing an appropriate tax-free covenant clause, the corporation paying a State tax or any other

[26] For method of securing advantage of the deduction, see Chapter XIX, "Income from Interest," page 678.

than a Federal tax for someone else pursuant to its agreement may deduct such payment as interest paid on indebtedness.[27] Under the revenue act of 1921 any tax paid by a corporation pursuant to a tax-free covenant clause need not be included in the gross income of the obligee. (Art. 565.)

The last sentence of this article is new.

Suggestion to corporations.—Corporations having "tax-free" covenant bonds are under no necessity to pay a tax on the interest of such bonds as are held by persons whose income is less than the personal exemption. They can make a saving by giving close attention to the form of certificates filed with them by such persons. Many bondholders with very small incomes are not careful to file the form of certificate which claims the exemption. Wherever feasible the certificates claiming exemption should be substituted for those not claiming exemption.

Ruling. If an individual who received during 1917 interest on bonds containing a tax free covenant clause was not liable to the payment of normal income tax for that year, the amount of tax paid at the source in his behalf by the debtor corporation is refundable to the debtor corporation, if such tax was not actually withheld from the individual bondholder. The amount of any income or excess profits taxes, or any installment thereof, shown to be due on the debtor corporation's income and profits tax return may be credited with the amount of the excess tax in question paid at the source. (B. 46-21-1924; O. D. 1103.)

Accrual Method Permitted

Since January 8, 1917,[28] when T. D. 2433,[29] (which held that under the 1916 law, effective as of January 1, 1916,

[27] [Former Procedure] Article 102 of Regulations 33, 1918, did not state specifically that "a State tax or any other than a federal tax" was deductible as interest.

[28] [Former Procedure]

Regulations. Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of the corporation. (Reg. 33, 1914, Art. 158.)

Reserves for taxes cannot be allowed, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted. (Reg. 33, 1914, Art. 156.)

[29] See page 379.

accrued liabilities, such as taxes, would be allowable deductions) was issued, the regulations have permitted the deduction of accruals for all taxes which in themselves are eligible subjects for deduction. Furthermore, the 1921 law plainly states that the term "paid" means "paid or accrued."[80] Consequently, all tax reserves, except those for federal income and excess profits taxes and for special assessments, are deductible. In these years of highly fluctuating profits, proper reserves for taxes are, of course, of great importance.

Accrual of New York State tax.—

Ruling. The New York State personal income-tax law, passed May 14, 1919, provides for the imposition of an annual tax upon income, and concludes with the statement that "such tax shall first be levied, collected, and paid in the year 1920, upon and with respect to the taxable income for the calendar year 1919, or for any taxable year ending during the year 1919."

A taxpayer of the state of New York who keeps his accounts upon the accrual basis, may in rendering his federal income tax return for 1919, deduct the accrued tax for his fiscal year ended in 1919, imposed by the New York state personal income tax law, provided such fiscal year ended subsequent to May 14, 1919, the date of passage of the State taxing act. In case his fiscal year ended prior to May 14, the accrued tax would not be deductible in his Federal income tax return for 1919 since it was not a known liability at the time of closing his accounts for such fiscal year.

In the event of judicial interpretation of the New York state personal income tax law which would have the effect of changing the individual's tax liability thereunder it would be necessary for him to file an amended return for Federal income tax purposes. (C. B. 2, page 121; O. D. 505.)

New York State franchise tax to be prorated when reporting on a calendar year basis.—

Ruling. The New York State franchise tax, imposed for the privilege of doing business in that State for the fiscal year of the State ending October 31, 1920, is based on 1918 income, but is not due and payable until a later date. A taxpayer making a calendar-year return on an accrual basis may deduct two-twelfths of such tax in his return for 1919 and ten-twelfths in his return for 1920. (C. B. 2, page 112; O. D. 371.)

[80] Section 200 (4).

State of Wisconsin—surtax for 1920.—

RULING. Chapter 459 of the Session Laws of 1921, for the State of Wisconsin imposes an additional surtax on net income in excess of $3,000, retroactive for the year 1920. Inquiry is made whether taxpayers who are called upon to pay this additional tax for 1920 are entitled to recompute their Federal income tax for that year, taking into consideration the additional surtax imposed by said act of the Wisconsin Legislature.

Held, that since the surtax was not such a known liability at the time of closing their books for 1920 as to justify them in setting up an accrual for such surtax, it is not an allowable deduction from gross income for 1920, but is deductible by the taxpayers in the year in which paid, or in which liability therefore accrued, if the books of the taxpayers are kept on an accrual basis. (B. 48-21-1949; O .D. 1118.)

[Former Procedure]

MUNITION MANUFACTURER'S TAX—TITLE III, SECTION 302 (C) (D), ACT OF SEPTEMBER 8, 1916.—

RULING. 1. Only taxes and interest actually paid within the taxable year may be deducted from gross income in munition manufacturer's tax returns for the years 1916 and 1917.

2. Income taxes paid for 1915 in 1916 may not be deducted from gross income.

3. Only that interest is deductible which was actually paid within the taxable year on debts or loans which filled both of two requirements: (1) That they were contracted to meet the needs of the munition business and (2) that the proceeds thereof were actually used to meet such needs. Interest paid within the taxable year on that part of the principal used in the munition business in 1915, if any, from which the profit is not returned for the purpose of the munitions tax, is not deductible. (C. B. 4, page 145; L. O. 1057.)

METHOD OF COMPUTING AND ACCOUNTING FOR MUNITION MANUFACTURER'S TAX WHEN TAXPAYER'S ACCOUNTS ARE KEPT ON THE ACCRUAL BASIS.—

RULING. Where a corporation in 1916 kept its accounts on the accrual basis, and either accrued munitions taxes or credited amounts to a reserve set up to meet such taxes, thus taking advantage of section 13 (d) of the Revenue Act of 1916, it became bound by the provisions of that section and Treasury Decision 2433, and the amounts so accrued or credited must, in computing income subject to tax for 1916, be deducted from gross income for that year, and not for 1917, during which year such munitions taxes were paid.

Section 13 (d) of the Revenue Act of 1916 is a qualifying section, and when accounts of a corporation are kept on a basis other than that of receipts and disbursements it qualifies the manner of making deductions authorized in section 12 (a) of the Act, and the word "paid" in the latter section is to be read "paid or accrued" depending on how the accounts of the corporation are kept. (C. B. 4, page 147; L. O. 1059.)

CHAPTER XXIX

DEDUCTIONS FOR LOSSES

Preceding chapters discuss the deductions for expenses, interest and taxes. The new concept of capital gains and losses introduced in the 1921 law is treated in Chapter XVII. It remains to discuss the deductions embraced within the comprehensive term "losses." It is desirable to subdivide this subject and to devote separate chapters to the special items, namely, losses due to bad debts, depreciation, obsolescence, depletion and gifts. (Chapter XXX to XXXIV.) Consequently the subject matter of this chapter is a residuum consisting of the losses due to general and miscellaneous causes, including fluctuation in market values, to disasters and accidents of various kinds, to dishonesty, to faulty judgment, etc., etc.

Until the 1918 act became effective, individuals were subject to a very definite restriction in that losses incurred by them in transactions entered into for profit outside their regular trade or business were deductible only to an amount not exceeding profits arising from similar transactions.[1]

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[1] **[Former Procedure]** The provision of the 1913 law relating to the deduction of losses by individuals was as follows:

1913 Law. "Section II (b) . . . . fourth, ... losses actually sustained during the year, incurred in trade or arising from fires, storms or shipwreck, and not compensated for by insurance or otherwise. . . . ."

The 1916 law introduced the March 1, 1913, basis of valuation and the provision permitting "outside" losses, equal to profits arising from similar transactions, to be deducted.

The 1916 and 1917 laws contained the following:

1916 Law. "Section 5. [Individuals] . . . . (a) . . . . Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: . . . .

"Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom."

Until recently the Treasury has restricted the word "profits" to mean only those gains derived from the sale or other disposition of the investment itself.

The Solicitor in a recent ruling has broadened this definition:[2]

RULING. It is therefore held that all returns—e.g., dividends, rents, interest, surplus from sales, etc.—actually realized within the taxable year from subordinate endeavors entered into for profit are "profits" within the meaning of the fifth deduction, sec. 5 (a), Revenue Act of 1916; and that losses actually sustained within the same taxable year by reason of similar transactions, closed and completed, may be offset to the extent of such realized profits. (C. B. 4, page 163; L. O. 1061.)

The foregoing ruling is retroactive. Taxpayers who had losses in 1917 which were not deducted because of the regulations then in force, may now file claims for refund.

The 1918 law included certain "relief" provisions[3] designed to prevent hardship during the period following the war from possible violent changes in inventory values.

The administration by the Treasury of the section relating to declines in value of 1918 inventories has restricted the relief to far less than Congress intended when it enacted the 1918 law. The 1921 law contains no provision similar to the inventory loss provision contained in sections 214 (a-12) and 234 (a-14) of the 1918 law. Section 204 of the 1918 law was so narrowly construed by the Treasury as to deprive some taxpayers of relief who are entitled to it. The 1921 law con-

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The following ruling is of importance of those whose principal occupation prior to 1918 was trading on margin:

RULING. "An individual was daily in touch with his broker during 1917, purchasing and selling stocks exclusively on margin, sustaining losses on some transactions and realizing gains on others, the net result being a loss.

"Since he devoted sufficient time and attention to the purchase and sale of stocks to constitute a vocation, and since all purchases and sales were made on margin, thereby indicating that the shares of stock were purchased for resale and not as an investment, it is held that the amount of the loss represents an allowable deduction in computing net income for 1917." (C. B. 4, page 157; A. R. R. 404.)

[2] See also Bulletin 32-21-1760; A. R. R. 604.

[3] Section 214 (a-12) for individuals, and section 234 (a-14) for corporations.

tains a "net loss" provision[4] similar in principle to section 204 in the 1918 law, which permits the application of the loss of one year against the net income of a later year. In its application, however, the 1921 "net loss" provision differs materially from the corresponding section of the 1918 law. It is discussed at the end of this chapter, page 1021 *et seq.*

The chief problems to be discussed in this chapter are, therefore, the determination of procedure under these special "relief" provisions and the establishment of the standard by which to measure losses due to diminution in values. This second problem is similar to that discussed in Chapter XVI, "Income from Exchanges and Sales of Property."

Losses Which Are Deductible

In a broad sense there are no limitations, under the 1921 law, upon the right of individuals and corporations to deduct all losses sustained during the taxable year 1921, whether or not incurred in business or trade. There are certain requirements such as those regarding transactions entered into for profit, "wash sales," etc., but in general all losses may be deducted. The restrictions are fully discussed in the following pages.

Individuals.—

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only if and to the extent that the profit, if such transaction had resulted in a profit, would be taxable under this title. No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date

[4] Section 204.

of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. Losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

Corporations.—

LAW. Section 234. (a) . . . . (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;[5] unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within 30 days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for

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[5] [Former Procedure] The corresponding clause in the 1913 law read:

LAW. Section II, G (b) . . . . "all losses actually sustained within the year and not compensated by insurance or otherwise."

1916 LAW. "Section 12. (a) . . . . Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise. . . . ."

It should be noted that the 1916 law reads "actually sustained and charged off." The words "and charged off" did not appear in the section relating to individuals and were inserted in the corporation section only in 1916.

The 1918 law omitted the words "and charged off" which formerly appeared, but it is to be assumed that losses will not be allowed unless charged off by items or through reserves.

any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a transaction made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

REGULATION. . . . . If (1) a corporation sells its capital assets for less than their cost, and such assets were acquired before March 1, 1913, then if the fair market value on March 1, 1913, less depreciation subsequently sustained and allowable as a deduction is less than the amount realized, no loss is deductible; if (2) such fair market value less depreciation subsequently sustained and allowable as a deduction is greater than the amount realized, but the amount realized exceeds original cost, no loss is deductible; if (3) the amount realized is less than both original cost and the value of March 1, 1913, less depreciation subsequently sustained and allowable as a deduction, the deductible loss is the difference between such amount realized and such cost or March 1, 1913, value, whichever is lower. . . . . (Art. 563.)

Losses, to be allowed as deductions, must meet the provisions of the law that they have been actually "sustained." This is a reasonable requirement. Most concerns charge off or provide reserves for losses as and when losses occur and the items to be deducted can be taken directly from the books. In the case of individuals who keep no books, more difficulty is experienced.

In discussing the phrase "losses sustained" the regulations state that this condition "must usually be evidenced by closed and completed transactions."[6] This, however, does not preclude the use of inventories for the purpose of ascertaining gains or losses. The privilege of using inventories, long permitted to business men generally in the case of merchandise, was not extended to dealers in securities until late in 1917; but at that time was supported by an opinion of the Attorney General who advised that the Supreme Court in a case under the 1909 law sanctioned the practice. For a

[6] Reg. 62, Art. 141.

full discussion of inventories the reader is referred to Chapter XV, page 452 *et seq.*[7]

If an individual is engaged in business on his own account or as a partner and the year's operations result in a net loss, the amount of such loss is an allowable deduction from income from other sources in a tax return.

The Treasury has ruled that a partnership which holds all of the stock of a corporation and provides funds to liquidate losses incurred by that corporation, may not deduct such payments as losses of the partnership.

In the case of a partnership which incorporates and commences its operations as a corporation during a taxable year, the loss sustained by the partnership during the portion of the taxable year it was operating cannot be deducted from the income of either the preceding or succeeding taxable year unless the circumstances are such that it can, and does, take advantage of section 330[8] of the 1918 law and elects to be taxed as a corporation for the full taxable year.[9]

Losses may be deducted in year sustained.—The 1921 law[10] permits losses to be deducted in a year other than the one in which the loss was sustained.[11]

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[7] See also page 985.

[8] Section 229 of the 1921 law is analagous to the third paragraph of section 330 of the 1918 law.

[9] C. B. 4, page 54; O. D. 855. See also B. 29-21-1736; A. R. R. 571.

[10] Sections 214 (a-6) and 234 (a-4).

[11] **[Former Procedure]** The 1918 and prior laws did not contain this specific provision. Losses, however, were supposed to be deducted in the year when sustained, and the Commissioner had full power to permit amended returns in cases where the discovery was in a later year. The following ruling illustrates the narrow interpretation of the 1918 law.

Ruling. "The M Company in 1918 delivered under a bona fide sale goods guaranteed as to quality until July 1, 1919. On inspection of a portion of the goods in May, 1919, they were found unsuitable, and to save loss resulting from a complete inspection a compromise resale to the M Company was effected at the original purchase price less certain concessions.

"Held, that the M Company may not take into its inventory as of December 31, 1918, the goods delivered in that year and that the resale established a basis, in the taxable year 1919, for determining loss." (C. B. 4, page 47; A. R. M. 129.)

Regulation. As a general rule losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable year in which sustained. In exceptional circumstances, however, in order to avoid injustice to the taxpayer and to more clearly reflect his income, the Commissioner may permit a loss to be accounted for as of a year other than the one in which sustained. For example, an embezzlement or a shipwreck may occur in 1921 but not become known until 1922 and in such a case income may be more clearly reflected by accounting for the loss as of 1922 rather than of 1921. If a taxpayer desires to account for a loss as of a period other than the one in which actually sustained, he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner, together with a complete statement of the facts upon which he relies. However, in his income tax return he shall deduct the loss only for the taxable year in which actually sustained. Upon the audit of the return the Commissioner will decide whether the case is within the exception provided by the statute; if not within the exception the loss will be allowed only as of the taxable year in which sustained. The allowance of a deduction for a loss in a year other than the one in which sustained is entirely within the discretion of the Commissioner and he will consider exercising this discretion only in exceptional cases. A shrinkage in the value of the taxpayer's stock in trade, as reflected in his inventory, is not such a loss as is contemplated by the provision of the statute authorizing the Commissioner to allow the deduction of a loss for a taxable year other than the one in which sustained. (Art. 146.)

The word "sustained" as used in the law is of doubtful meaning. If used in its ordinary meaning taxpayers should not be permitted to shift losses to periods not affected. If the word is synonymous with "discovered" it is quite proper that losses discovered in one year should not be related back to the period when sustained. The illustrations used in Art. 146 indicate that the word "sustained" is synonymous with "become known," and therefore with "discovered."

[Former Procedure—Continued]

It is obvious, in the foregoing ruling, that the loss arose in 1918. The true net income could only be determined by filing an amended return. It is assumed that the loss was an extraordinary one; otherwise it should have been absorbed in 1919.

Determination and Measurement of Property Losses

The determination and measurement of losses due to a diminution in the value of property involve the same problems of procedure as those which are discussed in detail for the determination and measurement of profits from transactions in property. (See Chapter XVII.) It happens that the important cases which have been decided by the Supreme Court have arisen from additional assessments imposed by revenue officers because of alleged failure to report property gains in full, but the principles established in these decisions apply with equal force to property losses.

Property acquired before March 1, 1913.—The 1916 law in referring to individuals specifically declared "that for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal and mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amounts of such loss sustained."[12] Using practically the same language, section 10 of the 1916 law established this basis for corporations also. In other words, only losses sustained after March 1, 1913, are deductible. The principle laid down in the 1918 law was the same.[13]

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[12] **[Former Procedure]** The 1913 law did not contain this specific provision and for a time there was doubt as to proper procedure. Under the 1913 rulings losses when deductible were prorated over the whole time the property was held, and that part of the loss apportioned to the taxable period appeared in the annual returns. The apportionment was made as of January 1, 1909, in the case of corporations and March 1, 1913, in the case of individuals. This procedure was disputed and there were many unsettled cases. These may now be adjusted in the light of the Supreme Court decisions discussed in detail in Chapter XVII.

[13] **[Former Procedure]** It will be noticed that in the following ruling under the 1918 law no consideration was given to the cost of property acquired prior to March 1, 1913.

RULING. "A taxpayer who, prior to March 1, 1913, purchased bonds which had a market value as of March 1, 1913, above par, and which were redeemed at par in 1919 is entitled to deduct, as a loss in 1919, the differ-

The 1921 law,[14] however, restricts losses deductible in respect of sales or other disposition of property acquired prior to March 1, 1913, to the lesser of the differences between the sale price and the cost or March 1, 1913, value, respectively.

Shortly stated and eliminating depreciation, obsolescence and depletion (which the law states are to be calculated upon

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ence between the market value on March 1, 1913, and the value received in 1919 upon the maturity of the bonds." (C. B. 2, page 132; O. D. 506.)

Under the 1921 law the loss would be allowed as computed in the above ruling, only if the cost prior to March 1, 1913, was equal to the value of the bonds at that date. If the cost was less than March 1, 1913, value the deductible loss would be correspondingly reduced.

An important question to be considered is whether this restriction of the 1921 law is to be deemed to be interpretive of the corresponding loss provisions in previous laws. During 1921 the Supreme Court decided in the cases of *Goodrich v. Edwards* and *Brewster v. Walsh*, that an apparent profit representing the difference between value at March 1, 1913, and subsequent sale price was taxable only to the extent that it exceeded original cost of the property. In other words, only actually realized income was intended to be or could be taxed. The Solicitor General, in a brief filed in these cases, contended that if the taxable gain should be limited to the excess of sale price over value at March 1, 1913, or cost, whichever was higher, the allowance for losses should be restricted to the difference between value at March 1, 1913, or cost, whichever was lower.

The court, however, expressed no opinion with respect to the manner in which losses should be computed as this question was not at issue.

Nevertheless, immediately after the decisions in the *Goodrich* and *Brewster* cases (prior to the passage of the 1921 law), the Treasury amended its regulations pertaining to the determination of profits or losses on sales of property acquired prior to March 1, 1913, embodying therein the method of computation now prescribed by the 1921 law. In the author's opinion these regulations were illegal. The basis of taxing gains must be governed by the sixteenth amendment; there is no inhibition regarding allowable deductions. Congress could allow taxpayers to deduct 150 per cent of losses if it cared to, but it could not increase taxable income 1 per cent. As the 1918 and prior laws permitted deductions on the basis of March 1, 1913, values irrespective of cost, the allowance stands until December 31, 1920, when it was taken away by the 1921 law.

Taxpayers who prior to 1921 were entitled to larger deductions for losses, if based on the language of the 1918 and prior laws, than are allowed under the Treasury's regulations as amended in 1921, should pay under protest any taxes assessed on the latter basis. The question has not been decided in court but it is of sufficient importance to litigate.

[14] Section 202 (b).

March 1, 1913, value irrespective of prior cost), any appreciation at March 1, 1913, which does not continue until realization cannot be allowed as a deduction. This is fair enough.

A bond cost $700 in 1910; its market value was $900 on March 1, 1913; it is sold for $700 in 1922. There is no allowable deduction for the apparent loss, based on March 1, 1913, value. If sold for $600 there is an allowable loss of $100. If the value of the bond on March 1, 1913, was $600, and it is sold for $500, the allowable loss is only $100, whereas the actual loss as compared with cost is $200. In practice the 1921 law restricts allowable losses to March 1, 1913, values when such values were below cost, and to cost when cost was lower than March 1, 1913, value, under the theory that whatever taxpayers had on March 1, 1913, was their capital. The law works equitably as long as full deduction can be made when any part of such capital is lost. But when deduction is denied because March 1, 1913, value is less than cost and deduction is also denied because appreciation at March 1, 1913, did not continue, the comment "fair enough" applied to the latter contingency is withdrawn because the principle of capital value March 1, 1913, irrespective of cost is departed from.

The measure of deductible losses is not the same as that of taxable gains; but as the computation in case of gains is so nearly like the computation in the case of losses, it is easier to discuss and illustrate the computation in one place. Therefore, the discussion will be found on page 569 *et seq.*

Property acquired after March 1, 1913.—

Regulation. For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. . . . . (Art. 1561.)

Determination of value on March 1, 1913.—The process of determining the value at March 1, 1913, of property purchased before that date is fully discussed in Chapter

XVII. Suffice it to say here that the question is of enough importance to justify the collection of data which may serve to establish true values as of that date. In the absence of such data the Treasury would probably have assumed (prior to the 1921 law) that the March 1, 1913, value was the same as original cost less depreciation. In view of the new definition of losses deductible upon disposition of property acquired prior to March 1, 1913, which is contained in the 1921 law [Section 202 (b)], it is quite conceivable that the taxpayer may be required by the Treasury to prove that the March 1, 1913, value was at least equal to cost of the property before allowing a loss claimed for difference between cost before and sale price after March, 1913.

The 1921 law provides that exchanges and reorganizations are closed transations (a) when property received has a readily realizable market value, *and* (not "or") (b) the property received is of a different nature than that parted with.[15] These requirements are fully discussed on page 536 *et seq.*, and need not be repeated. Shortly stated, losses cannot be deducted unless there is a closed transaction.[16]

Establishment of loss by inventory method.—Inventories are now prescribed as "necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor."[17] Prior to 1917 the use of inventories was permitted for the purpose of establishing gains or losses only in the case of merchants and manufacturers. For a full discussion of this subject the reader is referred to Chapter XV. Permission to use the inventory method has been extended to

[15] **[Former Procedure]** The 1918 law, section 202 (b), provided that "when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any."

[16] For discussion of closed transactions see also *Income Tax Procedure, 1921*, page 793 and Chapter XV.

[17] See page 453.

dealers in securities. Valuation at "cost or market whichever is the lower" is permitted.[18]

INVENTORIED SHRINKAGE IN SECURITIES DEDUCTIBLE ONLY BY DEALERS.—Stocks and bonds owned by others than dealers may not be revalued periodically and losses may not be charged off by the inventory method. Neither can amounts invested in foreign money be so treated when merely due to a fall in exchange.[19] Excepting when investments became worthless,[20] they must mature or be sold to establish a loss.

REGULATION. A person possessing stock of a corporation can not deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. . . . . (Art. 144.)

WHEN DEDUCTION FOR SHRINKAGE MAY NOT BE CLAIMED BY HOLDERS OF LIFE OR TERMINABLE INTERESTS.—

REGULATION. No deduction shall be allowed in the case of a life or a terminable interest acquired by gift, bequest, or inheritance, where the estate or trust is entitled to a deduction under the statute but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss but must include in his return the full amount distributed or distributable. . . . . (Art. 295.)

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[18] **[Former Procedure]** Before December 19, 1917, shrinkage in the value of securities was not allowed as a deduction even when they were the stock-in-trade of a dealer. This position is illustrated by the following Treasury decision:

REGULATIONS. "This ruling, in so far as it relates to depreciation . . . . is not to be construed as recognizing any gain or loss due to fluctuations in the market value or arbitrary changes in the book value of securities and like assets, the gain or loss with respect to which will be determined only when such assets mature, or are sold or disposed of —that is, when there is a completed, a closed, transaction." (T. D. 2077, November 21, 1914.)

"Losses of this character are only ascertainable when the securities mature, are disposed of, or cancelled." (T. D. 2152, February 12, 1915.)

[19] C. B. 4, page 155; O. D. 764.

[20] See page 988.

Section 215 (b)[21] of the 1921 law, on which the above article is based, enacted into law the procedure laid down by the Treasury in article 347 of Regulations 45. That article gave effect to an interpretation for which there was little or no warrant in the law itself.[22]

German investments—when determined worthless.—When securities bought in Germany for 300,000 marks (value at time of purchase $9,000) are sold for 500,000 marks (value at time of sale $5,000), the loss of $4,000 is deductible from income.[23]

Ruling. Receipt is acknowledged of your letter of the 10th inst., in which you state an American corporation owns some German investments. You desire to be advised whether or not this corporation can charge off such investments as an actual loss and deduct the same in preparing its return of annual net income with the understanding that any amounts subsequently received will be credited to income in subsequent years.

In reply you are informed that the tax law makes an allowance for a deduction from gross income of all losses actually sustained by a corporation during the year for which the return is made. However, in the case you mention it does not appear that a loss which is definitely known has been sustained from a closed and completed transaction. Therefore, it is necessary to hold that the American corporation in question can not deduct an amount representing a part or the whole of the German investments inasmuch as at best this deduction would be merely estimated and not a loss from a closed and completed transaction. (Letter to Lybrand, Ross Bros. & Montgomery, New York, signed by Deputy Commissioner L. F. Speer, and dated September 18, 1918.)

Russian investments.—

Ruling. Because of disturbed political conditions in Russia there is little hope that bonds of the Imperial Internal Russian 4 per cent loan of 1894 will be redeemed. A holder of such bonds which were purchased in 1916, who was unsuccessful in finding a market for them during the year 1919, is entitled to a deduction from his gross income for that year to the extent of the amount actually paid for them, provided, however, that such amount is

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[21] See Chapter XXXVII for text.

[22] This question was discussed at some length in *Income Tax Procedure*, 1921, pages 1040-1046.

[23] C. B. 4, page 234; O. D. 809.

charged off the taxpayer's accounts for the year 1919 and a corresponding reduction made in his surplus account. (C. B. 3, page 167; O. D. 748.)

Losses on Liberty bonds distributed in dividends.—The recipient of a dividend paid in Liberty bonds or other securities should return the dividend for taxation at the market value of the securities at the time of their receipt.[24] The corporation paying the dividend should charge to dividend account the market value of the securities distributed. If the market value at time of distribution is less than the price paid for the securities, the difference should be charged off as a loss.

The Treasury held in an earlier ruling that such a loss is not an allowable deduction,[25] on the ground that a transaction conducted by a corporation with its stockholders is not of a character to affect the amount of its net income. This argument was inconsistent with the Treasury's rulings, to the effect that the corporate entity must be disregarded when used to avoid the payment of tax on income. This inconsistency was evidently recognized, since in a later ruling[26] the Treasury allowed as a deduction the net difference between the market value at March 1, 1913, of securities and their value when distributed as a dividend in 1917.

When deduction may be claimed for shrinkage.—

Regulation. . . . . However, if stock of a corporation becomes worthless, its cost or other basis determined under section 202 may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness be made, as in the case of bad debts. Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders or general policy of such supervisory officers charge off stock as worthless or write it down to a nominal value, such stock shall, in the absence of affirmative evidence clearly

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[24] See article 1544, page 579.
[25] C. B. 1, page 28; O. D. 262.
[26] C. B. 4, page 27; A. R. R. 435.

establishing the contrary, be presumed for income tax purposes to be worthless.[27] . . . . (Art. 144.)

Heretofore when a taxpayer has had worthless stocks he has been compelled to go through the farce of selling them to someone for a dollar before the loss could be deducted.

Losses on sales of securities.—There has never been any question as to the deductibility of losses sustained by corporations arising out of the *sales* of securities (treasury assets) at less than cost, because there were no limitations in the sections of the laws relating to corporations such as formerly applied to individuals. But a loss must be actually "sustained" to be an allowable deduction. It must have more evidence than a book entry to support it.

When sales of assets are made to stockholders at less than book value the burden of proof is on the corporation to show that the sales prices are fair and reasonable. Otherwise it can hardly be held that an actual loss has been sustained.

If sales to stockholders are made at less than book value, and also at less than market or fair value, the stockholders have, in effect, made a "bargain" purchase. If sales by the individuals are made subsequently at prices higher than cost the resulting profit no doubt will be reported, but such procedure will not offset the fictitious loss created on the corporation's books if the corporation has taxable income subject to the excess profits tax. Corporations selling securities to their own stockholders at less than fair or market value cannot expect to secure credit for any book loss created thereby.

If, however, the corporation is not permitted to deduct the loss, the stockholders cannot be charged with having made a bargain purchase, and upon any resale they would be taxable

[27] **[Former Procedure]** Reg. 45 (1918), Art. 144, specifically excluded "dealers in securities" from the provisions of that article. The omission in the present article has no significance in that "dealers in securities" are allowed to inventory their securities on hand.

only upon the price realized in excess of the book value of the securities as shown by the books of the corporation.[28]

The basis for determining the loss when securities of the same issue, which were bought at different prices, are sold at a loss is given on page 587.

Ruling. (1) Where a new corporation is organized having the same stockholders with the same stockholdings as the old corporation, to which the old corporation transfers a large amount of stocks and bonds at a loss, less than one per cent of the purchase price being paid in cash and the balance being paid for by notes secured by the stocks and bonds sold, possession of which was retained by the old corporation with power of sale in case of default, the new corporation having no other assets, the whole transaction will be regarded as a sham and a subterfuge to evade taxation and the loss will be denied. . . . . (C. B. 3, page 160; L. O. 1035, revised.)

In the foregoing ruling the Treasury did not hesitate to disregard the corporate entities.

Contributions by stockholders.—The stockholders of a corporation "on the verge of bankruptcy" in 1920 surrendered 70 per cent of their stock to the creditors. The owner of 100 shares had paid $10,000 for it; he retained 30 shares. The Treasury held that the 30 shares must be carried as worth $10,000 "until the stock now held is sold or otherwise disposed of, or becomes worthless, in whole or in part."[29] The ruling fails to pass on the allowable deduction. In view of the imminence of bankruptcy, it would seem that the $10,000 had become worthless "in part" at least, to the extent of $7,000.

Assessments on stock.—

Regulation. . . . . An assessment paid by a stockholder of a national bank on account of his statutory liability . . . . may in certain cases represent a loss. . . . . (Art. 293.)

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[28] Reg. 62, Art. 147. For full discussion see page 994.
[29] I-3-33; I. T. 1168.

Application of tax-free distributions in computing losses.—

LAW. Section 201. . . . . (b) . . . . **If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in Section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon. . . . .**

REGULATION. . . . . A distribution made by a corporation out of earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913,[30] is exempt from tax, even if in excess of the cost or other basis provided in articles 1561-1563 and 1568, of the stock on which declared. However, where any tax-free distribution out of earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, has been made, the distributee can not deduct any loss from the sale or other disposition of the stock unless and then only to the extent that the cost, or other basis, exceeds the sum of (1) the amount realized from the sale or other disposition of the stock, and (2) the aggregate amount of such distributions received by him thereon.

Example.—A purchased certain stock subsequent to March 1, 1913, for $10,000 and received in 1921 a distribution thereon of $2,000, paid out of the earnings of profits of the corporation accumulated prior to March 1, 1913. This distribution does not constitute taxable income to A. If A subsequently sells the stock for $6,000 a deductible loss of $2,000 is sustained. If he sells the stock for $12,000, a taxable gain of $2,000 is realized. No gain or loss is recognized if he sells the stock for an amount ranging between $8,000 and $10,000 (Art. 1543.)

In the foregoing example the question of whether cost or value at March 1, 1913, is to be used as a basis for computing gain or loss is not considered since the stock was acquired after March 1, 1913.

Assume A owns 100 shares of stock purchased in 1910 for $10,000, and that at March 1, 1913, the value of such stock was $15,000. In 1918 and 1919, A receives $2,000, "dividends" paid out of earnings accumulated prior to March

[30] See pages 715-718.

1, 1913, or out of appreciation accrued at that date.[31] In 1921, A sells his 100 shares for $7,000. Under section 202,[32] A would determine his loss by deducting the sales price ($7,000) from the cost ($10,000) (since the March 1, 1913, value $15,000 is higher than cost). The resulting loss is $3,000. But "the amount realized from the sale" ($7,000) plus the tax-free "dividends" ($2,000), or a total of $9,000, when compared with the cost ($10,000), results in a loss of only $1,000. In other words, the loss which would ordinarily be deductible ($3,000) is reduced by the aggregate amount of the tax-free "dividends" ($2,000).

In case a gain is realized, the tax-free distributions are ignored. If in the illustration above the 100 shares had been sold in 1921 for $20,000, the profit would be $5,000 (excess of sales price, $20,000, over March 1, 1913, value $15,000).

Stated in tabular form we have:

CASE "A"

(a) Cost of Stock before 1913	(b) Value of Stock March 1, 1913	(c) Tax-free "Dividends"	(d) Sale Price	(e) Loss under Section 202 (a-d)	(f) Loss to be Reported in Tax Return (a-c-d)
$10,000	$15,000	$2,000	$7,000	$3,000	$1,000

CASE "B"

(a) Cost of Stock before 1913	(b) Value of Stock March 1, 1913	(c) Tax-free "Dividends"	(d) Sale Price	(e) Gain under Section 202 (d-b)	(f) Gain to be Reported in Tax Return same as (e)
$10,000	$15,000	$2,000	$20,000	$5,000	$5,000

It is well to note that if the sales price falls between the *reduced* basis (cost, or market value March 1, 1913, minus tax-free dividends) and said basis before reduction by the amount of tax-free dividends, no gain or loss is recognized. For example, if in case A above, the sales price had been $9,000,

[31] For discussion of appreciation realized through depletion charges, see Chapter XXXIII.

[32] See page 569.

there would be no loss. In case B above, if the sales price had been $14,000, there would be no gain because the sales price lies between cost ($10,000) and value March 1, 1913, ($15,000). In the latter case the tax-free "dividend" ($2,000) is ignored.[33]

"Wash sales" for the purpose of establishing losses.—So long as accrued losses (shrinkage in values of securities) are not deductible until "evidenced by closed transactions" it is only natural that attempts should be made to convert paper losses into actual losses in order to obtain the benefit of the deduction. If securities are sold at a loss to a *bona fide* buyer, with no agreement to repurchase nor any similar agreement, the loss has been legally established and becomes an allowable deduction. Sales through a stock exchange are actual and completed transactions because the seller has no control over the buyer. Subsequent repurchase of a similar amount of securities does not affect the *bona fides* of the transaction because the buyer takes a chance of having to pay a higher price and the transaction is in fact a new deal.[34]

Nevertheless the following section of the 1921 law must be considered:

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[33] For illustrations of gain or loss from liquidating dividends, see Art. 1545, page 749.

[34] [Former Procedure] Prior to the passage of the 1921 law, "sales to establish losses" were not in most cases questioned by the Treasury, as is evidenced by the following ruling issued in 1919:

RULING. If a taxpayer makes an actual bona fide sale of securities at a loss in 1918, the loss is deductible even though the taxpayer repurchases the securities in the succeeding year at the same price for which they were sold. However, the burden of proof will be on the taxpayer to show that the sale was not fictitious. (C. B. 1, page 124; O. D. 103.)

In another case a taxpayer offered stock at public auction, with instructions to buy it in for his account if there were no other bidders. It was bought in for his account at a nominal price. The Treasury held that "the facts failed to disclose an actual sale of the stock in question. . . . . A person cannot be both seller and purchaser in the same transaction." (I-5-53; I. T. 1181.) Under the 1921 law such a loss would also be disallowed because of the repurchase "within 30 days."

LAW. Section 214. **(a) . . . . there shall be allowed as deductions:**

(5) . . . . No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed; . . . .

The following regulation outlines the procedure under the 1921 law:

REGULATION. An individual, other than one in the trade or business of buying and selling securities, or a corporation, other than a dealer in stocks or securities, can not deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities made after November 23, 1921, if within 30 days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. . . . . This provision is designed to prevent a taxpayer who owns securities, other than one in the trade or business of buying and selling securities, from selling and immediately repurchasing them or from purchasing substantially identical property and immediately selling the original securities and claiming as a deduction in computing net income the so-called "loss" sustained therefrom. Gain or loss, however, is realized in the case of the "short sale." Under this section a taxpayer owning a hundred shares of stock in the X company, who purchases another hundred shares of stock in the X company and within 30 days thereafter sells the first purchased stock of the X company, can not deduct in computing net income any loss claimed to have been sustained from the transaction; if he sells the entire 200 shares of stock, a gain or loss from both transactions is realized at that time; and if he sells the stock of the X company included within the second purchase a gain or loss is realized thereby. (Art. 147.)

The 1921 law and the regulations are fair enough and will not result in any great hardships.

It is to be noted that sales made on or prior to November 23, 1921, (the date the 1921 law was passed) are not affected by the above provision. The status of such sales is the same as it would have been under previous laws.

The foregoing section applies to individuals but there is a similar provision applicable to corporations[35] which includes the statement, however, that the loss is to be allowed if "such claim is made by a dealer in stock or securities, and with respect to a transaction made in the ordinary course of its business." The section quoted above,[36] applicable to individuals, does not contain a similar statement because individuals or partnerships recognized as dealers in securities would not claim deductions for their losses on securities, under section 214 (a-5), but under section 214 (a-4), which latter section allows a deduction for "losses . . . . incurred in trade or business." Section 214 (a-4) does not contain the thirty-day limitation on re-acquirement of securities sold at a loss.

Where deductions are not allowed under section 214 (a-5) or 234 (a-4), the securities acquired are deemed to have taken the place of the securities sold. In the case of subsequent sale of the acquired securities the cost or March 1, 1913, value, of the original securities would form the basis of loss sustained or gain derived therefrom. [See Section 202 (d-3) of the law, and article 1567.]

Losses arising from the sale of property acquired by gift.—Prior to 1921, deductible losses arising from the sale of proptrty by donees were comparatively easy to determine. Losses consisted of the difference between the value of gifts when received and the proceeds of sales. Under the 1921 law the basis of loss[37] is "the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift."

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[35] Section 234 (a-4).
[36] Section 214 (a-5).
[37] Section 202 (a-2).

In discussing gains realized by donees,[38] the difficulty of securing information was mentioned. It will no doubt be more difficult to secure data from donors regarding gifts when values have declined. In such cases donees will fail to receive the benefit of deductions to which they are entitled.

It may be that any loss will be denied on the ground that the transaction was not entered into for profit, but the Treasury has specifically ruled that losses arising from property acquired by gift or inheritance may be deducted.[39]

The provision of the law is of doubtful legality and expediency but its evolution will be interesting.

Congress may have invented a new method of reducing taxes. A taxpayer not subject to tax, owning investment property greatly depreciated in value, may make a gift of such property to another taxpayer subject to high surtax rates and the latter may sell the property and claim a very large loss.

Losses in speculation.—If a taxpayer buys "futures," hoping to sell the contracts at a profit, and instead is compelled to sell at a loss and claims credit for the loss in his income tax return, it becomes specifically an unlimited deduction under the 1921 law, and would also have become so under the 1918 law. Under the 1913 law the loss would not have been deductible. Under the 1916 and 1917 laws the loss would have been deductible to an amount of profits derived from similar transactions.[40]

Losses on sale of capital assets.—The chapters on appreciation in values (XVII) and sales and exchanges (XVI)

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[38] See page 623.

[39] See page 620.

[40] **[Former Procedure]**

Decision. "Losses incurred by a member of a partnership, engaged in manufacturing jute bags and bagging, through his individual dealings on a cotton exchange are not incurred in trade within the meaning of section II, subdivision B of the act of 1913, and therefore are not deductible in computing net taxable income under that act." *Mente v. Eisner*, 266 Fed. 161; T. D. 3029.

deal with the principles which underlie the deductibility of losses as well as the taxability of profits. It is therefore unnecessary to repeat under this subject heading the comments which are found in the chapters mentioned.

Losses must be sustained bona fide.—The Treasury has ruled that when property acquired by gift is transferred or ostensibly sold for considerably less than its actual value, the difference between actual value and the sales price is a gift and is not an allowable loss to the donor.[41] The ruling is sound. Deductions for losses should be those sustained *bona fide.*

Losses due to scrapping of buildings and machinery deductible.—

REGULATION. Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements will be deductible from gross income in a sum representing the difference between the cost of such property demolished or scrapped and the amount of depreciation sustained with respect to the property prior to its demolition or scrapping, and allowable as a deduction in computing net income. . . . . (Art. 142.)

Depreciation is an allowable deduction but not a compulsory deduction. If insufficient or no depreciation has been charged over a term of years, it is true that a strictly accurate method of accounting would call for the reopening of accounts for the entire past period, the restatement thereof and the preparation of revised profit and loss accounts. But business could not be conducted that way. Neither can it be expected that tax returns for past periods can be amended every time an item applicable to prior years turns up. The foregoing regulation if strictly construed would call for amended returns for as many years as elapsed during the time when insufficient or no depreciation was charged. If the amount involved is substantial, amended returns must and should be

[41] C. B. 4, page 45; O. D. 847.

prepared. The regulation, however, can hardly be intended to control the usual adjustments which are always necessary in dealing with depreciation, because exact rates will never be available. In most cases it will be sufficient to charge off the entire book loss during the period in which it is ascertained. The law itself seems to permit this.

RULING. When property is discarded and salvaged, the depreciation allowance plus the salvage value may slightly exceed or fall slightly below the cost of the property. In the case of a gain over cost this must be treated as income. If the depreciation allowance plus salvage falls below the cost, the difference may be treated as a loss.

The fact that a taxpayer in past years neglected to allow for sufficient depreciation does not make the resulting discrepancy between the book values of equipment and its salvage value at the time it is retired from service deductible as a loss within the intent of Section II G(b) second, act of October 3, 1913. In such cases the taxpayer may avail himself of a larger deduction for depreciation by submitting amended returns for previous years, and showing that the previous depreciation rate was not reasonable. (C. B. 1, page 120; S. 1217.)

Cost of demolishing old building on new site not deductible as loss.—

REGULATION. . . . . When a taxpayer buys real estate upon which is located a building which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building. (Art. 142.)

This regulation is sound because all so-called expenses in construction enterprises are proper capital expenditures, and the cost of demolition of an old building is a capital charge. This rests on the principle that there can be no operating loss or expense in a new business until after the business commences to operate.

RULINGS. A taxpayer sustains no deductible loss in the demoli-

tion of 80 per cent of his building for the purpose of reconstruction. The amount expended is an investment of capital and should be considered as a part of the cost of reconstruction. (C. B. 4, page 164; O. D. 773.)

Improved real estate consisting of several frame dwellings was purchased primarily for the purpose of enlarging a business plant. No deductible loss was sustained by reason of the sale of the buildings apart from the land for their salvage value, notwithstanding the fact that the taxpayer would have paid considerably less for the property had it been aware at the time of purchase of a fire regulation, then in effect, which prohibited the moving of the buildings. The value of the land exclusive of the buildings is presumed to be equal to the purchase price of the land and buildings less the amount received as salvage. (B. 37-21-1816; O. D. 1031.)

Business Losses

The language of the statute is so broad in dealing with business losses that the problems of procedure are few and simple.

Losses incurred in transactions entered into for profit.—Under section 214 (a-5) of the 1921 law an individual may deduct all net losses "if incurred in any transaction entered into for profit, though not connected with the trade or business." The chief factors which decide the deductibility of this class of losses are:

1. The loss must be an actual one. It must be more than conjectural. Generally speaking, the taxpayer must be "out of pocket" the amount of the loss.

2. The loss must have been sustained during the taxable year. If at the end of the preceding taxable year a taxpayer had mentally "charged off" a loss, it would not come within the Treasury's interpretation of when a loss occurs. The Treasury in its regulations dealing with a closed transaction fixed the date practically at the time of the obsequies and not at the time of death. For example, if a taxpayer purchased stock for $100 a share in 1921 and sold it on January 2, 1922, for $1 a share, the Treasury holds that the loss

was not sustained until 1922, even though the value of the stock on December 31, 1921, was the same as on January 2, 1922.

3. The transaction must have been undertaken for profit. If a man buys an automobile for pleasure purposes at one price and sells it for a lower price, the loss sustained is not deductible. If a man buys or builds a residence for his own occupancy and sells it for less than cost, the Treasury holds that the loss is not deductible.[42]

4. As heretofore stated, it must be a net loss. Any insurance, etc., received must be credited against the gross loss sustained.

Rulings. Section 214 (a) 5, Revenue Act of 1918, does not contemplate that a distinction shall be made between an investment in property or securities with the object of deriving an income from the capital employed, and an investment which is made for the purpose of realizing a profit on the resale of the property or securities purchased. (C. B. 1, page 124; O. D. 138.)

A loss sustained from the sale of property acquired by gift, bequest, devise, or descent (whenever property so acquired is as a matter of fact acquired for purposes of profit) is a deductible loss from gross income. Ordinary investment property so acquired is to be treated as having been acquired for purposes of profit unless the conduct of the recipient furnishes evidence to the contrary. (C. B. 1, page 122; T. B. R. 35.)

If a taxpayer purchases royalty interests in tracts of oil land (not including title to the land itself) and such interests prove worthless, as evidenced by all wells drilled proving dry or failing after producing very small quantities of oil, the loss sustained is an allowable deduction from gross income. (C. B. 2, page 128; O. D. 375.)

Losses arising from canceliation of contracts.—

Ruling. . . . . The question under consideration is whether a sum paid in 1919 by a company to be relieved from a contract for delivery of goods in 1918 and 1919 is deductible in 1918, the year in which the matter was negotiated, though the final agreement and adjustment and payment was not made until 1919. . . . .

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[42] Reg. 62, Art. 141. See page 1002.

In the present case the amount to be paid for the cancellation of the contract was not determined nor paid until 1919. The loss was not a *closed* and *completed* transaction until that time. Negotiations were entered into in 1918, but the final outcome of the same or the amount to be paid as liquidated damages, was not, and from the nature of things would not be, known until the final agreement and adjustment had been made. . . .

It is held that where a corporation pays liquidated damages in 1919 to be relieved from the terms of a contract which called for the delivery of goods in 1918 and 1919, the loss so incurred is deductible from gross income for the year 1919 rather than 1918. (C. B. 1, page 217; S. 983.)

The foregoing ruling may be sound when applied to the specific facts in the case under review. The general principles laid down are, however, subject to criticism.

In the case of government contracts canceled prior to but unsettled at December 31, 1918, the Treasury took the position in Regulations 45 that upon settlement thereof after 1918 any additional profit must be accounted for in 1918.[43]

The foregoing ruling holds to the contrary. Since the Treasury shifts its position according to the nature of the case, it is not wise to apply general principles to any case.

In a later ruling it is held that amended returns may be made to adjust items applicable to prior years.[44]

Losses sustained by individuals.—Losses deductible by an individual are described in the law by three phrases: first, losses incurred in trade or business; second, net losses sustained in transactions not connected with trade or business, when the transactions were entered into for profit; third, net losses sustained in transactions not connected with trade or business if arising from fire, storm, shipwreck or other casualty or from theft.

In all the foregoing it will be noted that the losses must be "net" losses—that is, the actual money loss sustained by the taxpayer. If reimbursed in whole or in part by an insurance

[43] For adjustment of government contracts, see page 532, Chapter XV.
[44] C. B. 3, page 147; A. R. R. 275.

company or compensated in any other way, the loss is not a net loss except as to any part not reimbursed.

This is not intended to mean that the taxpayer cannot deduct a loss based upon a revaluation. This point is covered on page 569. It may be further amplified in case the beneficiary of an estate subsequently sells stocks, bonds or any kind of property at a price less than the fair market or appraised price at the time when the property was received.[45] The measure of deduction is based entirely upon the valuation at the time when the property changed hands, and the loss is just as much deductible by the beneficiary of the estate as if the beneficiary had paid in cash the amount of the appraised value. This, of course, is subject to a general rule that depreciation must be always taken into consideration, but the rule depends on whether depreciation is an allowable deduction or not.[46]

Furthermore, the loss must be a property loss. Losses from casualties, thefts and other causes produce consequential losses which are in addition to and grow out of property losses, but the words "arising from" cannot be construed broadly enough to include anything but the loss of property itself.

Rulings. An amount paid by a former director of a bank in compromise of a suit against him by a receiver for dereliction and neglect of duty as such director is deductible as a loss within the meaning of section 214 (a) of the Revenue Act of 1918. (B. 45-21-1908; O. D. 1091.)

Damages paid by a taxpayer engaged in the real estate business pursuant to a judgment against him for misrepresentation of land sold are deductible from gross income under section 214 (a) 4 of the Revenue Act of 1918. (B. 29-21-1734; O. D. 978.)

Loss on sale of individual's residence.—

Regulation. . . . . A loss on the sale of residential property is not deductible unless the property was purchased or constructed

[45] Regarding losses on gifts, see page 995.
[46] See page 573.

by the taxpayer with a view to its subsequent sale for pecuniary profit. . . . . (Art. 141.)

If a taxpayer buys or builds or inherits a house (which he occupies as a residence), and sells it for less than cost, or value March 1, 1913, it cannot be claimed that the loss has been sustained in trade or business. Profits from any source are taxable, but losses are deductible only to the extent mentioned. If, however, the house is destroyed by casualty and not compensated by insurance, the actual loss is deductible since it happens to fall within a specific provision of the law.

RULINGS. A loss sustained by an individual from the sale of residential property is deductible in determining net income for purposes of the Revenue Act of 1918 only when the property was purchased or constructed by him with a view to its subsequent sale for pecuniary profit. The intent in purchasing or constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return. (C. B. 1, page 117; O. 780.)

A loss resulting from the sale of a taxpayer's residence caused by the acceptance of a business proposition requiring his removal to another part of the country is not a loss incurred in business or trade which is deductible under the Revenue Act of 1917. (C. B. 2, page 129; A. R. R. 96.)

The subletting of an apartment by a tenant on account of being required to make his residence in another city is held not to be a "transaction entered into for profit." Therefore any loss sustained through such transaction is not deductible from gross income. (C. B. 1, page 124; O. D. 42.)

The last quoted ruling is not sound and should be contrasted with a more recent office decision wherein it was held that a taxpayer who lives in an apartment where it was the custom of the residents to sublease their apartments for the summer months, may deduct the rent paid during the time the apartment was sublet.[47]

RULING. A taxpayer purchased property in 1917 for use as a personal residence, for which he paid $14x$ dollars. He made additions and betterments costing $4x$ dollars. He used the property as a personal residence until 1919, when he moved elsewhere and rented it.

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[47] B. 50-21-1972; O. D. 1134.

In 1920 he sold the property for $13\frac{1}{2}x$ dollars, and claimed a deduction of $4\frac{1}{2}x$ dollars as a loss arising from the sale.

It is held that if a loss is deductible at all it is deductible under section 214 (a) 5 of the Revenue Act of 1918 as a loss sustained in a transaction entered into for profit. However, the mere renting of property purchased without the intention at the time of purchase of making a pecuniary profit thereon does not constitute a "transaction entered into for profit" within the meaning of the statute, and as the taxpayer in the instant case purchased the property for a home, it was not his intention at the time to subsequently sell it for profit. It is therefore held that any loss sustained is not deductible for the purposes of the Revenue Act of 1918. (B. 52-21-1992; O. D. 1148.)

The question may well be raised, however, whether, after a taxpayer has discontinued using a dwelling for his residence and rents it to others, he has not at that time entered into a transaction for profit—the ownership of the dwelling no longer representing property held for personal use but an income-producing investment—so that if any loss were sustained upon eventual sale of the property it would be properly deductible.

Losses of the nature of personal expense not deductible at all.—It should be observed, first of all, that certain individual losses are not covered by any of the law's provisions. The law apparently considers as personal expense such losses as are not incurred in business or trade, nor due to casualty or theft, nor incurred in transactions entered into for profit outside one's own business. The *Primer* gives the following examples of losses of this non-deductible type.

Rulings. John Doe, while driving an automobile, ran down and injured another person. He either paid over a certain sum, or paid a judgment rendered against him, in settlement of the injury done. Can he claim the amount so paid as a loss?

No. It was not a loss which was incurred in the conduct of his business or trade, or which resulted from a transaction entered into for profit.[48] (*Income Tax Primer,* 1918, question 81.)

A professional man or a merchant owns and operates a "fancy

[48] C. B. 4, page 159; A. R. R. 444.

stock farm." The expenses of operation exceed the gross receipts. Can the difference be claimed as a deduction under the head of "losses"?

No. It is held that where a farm is operated for purposes of recreation or pleasure, and not primarily for profit, but as a hobby, that farm is not to be classed as a commercial enterprise, that it does not form a part of its owner's business or trade and until it is placed upon a profit-paying basis the gross receipts are not to be reported under "gross income" and the expenses are not to be claimed as a deduction. This ruling, of course, precludes the claiming of the difference between the two amounts as a loss. (*Income Tax Primer*, 1918, question 85.)

Individual's share of partnership losses deductible.—

Regulation. Where the result of partnership operation is a net loss, the loss will be divisible between the partners in the same proportion as net income would have been divisible, and may be used as a deduction by the individual partners in their returns of income. (Reg. 33, 1918, Art. 30.)

The loss must be as ascertained at the end of the fiscal year of the partnership. If an individual has not changed his taxable year from the calendar year (as he is permitted to do) to a fiscal year which agrees with that of his firm, nevertheless the item of deduction representing his share of the partnership loss will be the amount shown by the partnership books, and, if a loss has accrued to the partnership between the end of its fiscal year and December 31, the individual must not claim credit therefor until the following year. By that time the apparent loss to December 31 may be absorbed by profits thereafter. The point to observe is that the amount of the deduction should agree exactly with the partnership books (subject to adjustment for tax-exempt interest, etc.) as closed for one full fiscal year.[49]

Individual's share of corporation losses.—When an individual is compelled to pay all or part of a corporation's losses it is important to consider the transaction from the points of view of both sides. It has been decided that a debt forgiven

[49] See Chapter XXIV, page 803 *et seq.*

is not income to the debtor. If not income to the debtor, because it was a gift, it would not be deductible by the giver.[50]

In many cases, however, the giver is fully justified in wishing to deduct the payment as a loss and is not concerned with how the debtor treats it.

When payments are made to a corporation to pay its debts or to wipe out a deficit or for any reason other than that of furnishing new capital to continue in business, the giver should specify that the amounts paid to the corporation are loans or advances and not additional payments of capital. If the loans cannot be repaid the amounts advanced may be charged off as bad debts.

REGULATION. The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. . . . (Art. 50.)

RULING. The surrender of stock for the purpose of wiping out an operating deficit can not be made the basis of a deduction in the returns of the individual stockholders. (C. B. 1, page 126; O. D. 216.)

If the foregoing ruling is sound (which is doubtful, because some elements of a realized loss are present) the stockholders should be able by sale or otherwise to conform to the technical requirements of the Treasury and establish the loss.

Losses in illegal transactions may be deductible.—The Treasury has taken the position that profits arising out of illegal transactions are taxable, but the new regulations are silent as to deductions for losses sustained on illegal transactions.[51] Section 214 (a-5) specifically permits the deduction of all losses if incurred in "any transaction entered into for profit."

As stated on page 447, recent federal laws have omitted the word "lawful" and income from gambling transactions is unquestionably taxable. If a taxpayer enters into an illegal

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[50] *U. S. v. Oregon-Washington R. & Nav. Co.*, 251 Fed. 211, 1918.
[51] **[Former Procedure]** Reg. 45, Art. 141, provided that "losses in illegal transactions are not deductible."

transaction he naturally hopes to make a profit out of it. If such profit is realized it is taxable. If it results in a loss, under the law it would seem to be a deduction. The law does not say "any lawful transaction," but does say "any transaction."

When gambling is lawful losses are deductible.—

Ruling. . . . . It is accordingly held that: (1) The entire amount of winnings from all wagering contracts should be returned in gross income under section 213 (a) of the Revenue Act of 1918, irrespective of the nature of the transaction, whether legal or illegal and notwithstanding the laws of the state in which such contracts are made.

(2) If, under the laws of the state in which the wagering contract is made betting or gambling is prohibited, such transactions are illegal and no deduction may be claimed under section 214 (a-5) of the statute for losses sustained in such illegal transactions, but if the laws of the state in which the wagering contract is made do not prohibit betting or gambling, such transactions are lawful and the entire amount of the losses sustained in the transactions may be deducted from gross income under section 214 (a-5). (Letter to The Corporation Trust Company, signed by Acting Commissioner Paul F. Myers, and dated July 12, 1920.)

It would seem from the foregoing that losses at Monte Carlo are fully deductible.

Losses which are considered capital expenditures.—A corporation, in order to obtain possession of its property, and faced with a lawsuit, compromised with a third party by paying an amount in settlement of certain claims.

Ruling. The Committee finds that an amount paid by the M Corporation to C in 1917 either constituted the purchase price of the interest which he had acquired through the arrangement originally entered into before incorporation between A and B, stockholders, and himself, or that the amount was paid to him by way of compromise to perfect the title of the corporation to certain property. In either event it was not a loss nor was it properly chargeable to the current expenses of the year. It was a capital expense and recoverable through depletion and depreciation deductions over the life of the property. (B. 51-21-1982; A. R. R. 701.)

Losses Arising from Fire, Casualties, Theft, etc.

The law includes among the allowable deductions, in the case of individuals and corporations, all "property" losses "arising from fires, storms, shipwreck or other casualty or from theft, and if not compensated for by insurance or otherwise." Such losses are deductible in full by an individual irrespective of whether or not the property lost was invested in a business or trade.[52]

RULING. If an automobile is purchased with the intention of using it in a business and it is appropriated to business uses primarily a loss sustained through its sale may be deducted in computing net income notwithstanding its occasional use for pleasure purposes. (C. B. 4, page 163; O. D. 943.)

Since there is provision in the law for business losses, and since Congress provided also for "other" losses, it may be possible to include losses due to destruction of, or damage to, automobiles, yachts and all sorts of personal property. The author is of the opinion that such losses should be held to be personal or family expenses, and not the sort of property losses properly deductible; but if Congress has deliberately provided otherwise, taxpayers cannot be criticized for claiming the deduction.

RULINGS. A loss sustained by reason of the damage of a pleasure automobile, due to an accident attributable to the icy condition of the streets, is not deductible under the provisions of section 214 (a) 6 of the Revenue Act of 1918, as a loss sustained by "other casualty." (C. B. 3, page 158; O. D. 629.)

A loss may be claimed by the owner of a business truck demolished in collision with a pleasure car provided that the truck was in use

[52] [Former Procedure] Under the 1913 law the Treasury took the opposite position. Thus T. D. 2005 (July 8, 1914) definitely asserts that only those losses are deductible which are sustained during the tax year "in trade." Section 5 [a] fifth, of the 1916 law permitted a limited deduction of losses in transactions entered into for profit but not connected with one's business or trade.

The words "other casualty" and "theft" appeared first in the 1916 law [section 5 (a)]. The phrase "and from theft" in the 1916 law is superseded by the phrase "or from theft" in the 1918 law, but the change is purely verbal.

in connection with the business of the taxpayer at the time of the collision. No deduction may be claimed by the owner of the pleasure car wrecked in the collision. (C. B. 4, page 160; O. D. 857.)

The reason for disallowing the losses claimed in the cases covered by the foregoing rulings is not clear. The law states that deductions are to be allowed for "losses sustained . . . . of property not connected with the trade or business . . . . if arising from . . . . casualty . . . ." An automobile is surely "property," whether used for business or pleasure purposes. A "casualty" is defined in the *Standard Dictionary* as "a . . . . serious accident . . . . ; that which occurs by chance; chance." Both the cases covered by the foregoing rulings would seem to come within the scope of section 214 (a-6).

Rulings. A ring lost by its owner and owing to the circumstances attending the loss he is in doubt as to whether it was stolen or merely misplaced or lost from his finger.

Unless he can establish the fact that the ring was stolen no deduction can be allowed on account of the loss.

Such a loss does not come within the meaning of the term "other casualty" as used in section 214 (a) 6 of the Revenue Act of 1918. This term embraces losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design of the one suffering the loss. (C. B. 2, page 130; O. D. 526.)

A taxpayer employed a contractor to build his house. The contractor absconded, leaving certain bills for material used in the construction of the house unpaid, and the taxpayer was required to pay such bills.

Held, that the additional amount paid represents additional cost of the building and is not deductible as a loss. (C. B. 4, page 213; O. D. 925.)

The amounts misappropriated by a guardian of a minor in the years 1917, 1918, and 1919 are allowable deductions for those years under the provisions of the Revenue Act of 1916, as amended by the Act of 1917 and the Revenue Act of 1918. (B. 50-21-1974; A. R. M. 144.)

Determination of the loss deductible.—

Regulation. . . . . When loss is claimed through the destruction of property by fire, flood, or other casualty, the amount deductible

will be the difference between the cost of the property, less proper adjustment for depreciation, and the salvage value thereof. In the case of property acquired before March 1, 1913, however, the deductible loss is the difference between the fair market value of the property as of that date, less proper adjustment for depreciation, and the salvage value thereof. In any event the loss should be reduced by the amount of any insurance or other compensation received. . . . . (Art. 141.)

RULINGS. A taxpayer's personal residence located on a beach was damaged by a storm, which washed away part of the foundation and so undermined the building as to render its destruction certain if it was not immediately removed. In removing the building to a safer location it was further damaged.

The damage caused by the direct action of the storm and by the removal to avoid further probable damage is held to have arisen from storm and deductible from gross income as a loss within the meaning of section 214(a) 6 of the Revenue Act of 1918. If the building was moved to prevent further loss from the storm in question, the expense of moving it is also deductible as a loss; but if it was moved to prevent probable losses from future storms, the expense of moving it is regarded as a capital expenditure and should be added to the cost of the building in computing profit in the event of its sale, since the removal to a safer locality presumably increased its value. (C. B. 3, page 159; O. D. 698.)

Damage to the flooring and furniture in the residence of a taxpayer caused by the freezing and bursting of water pipes, and not compensated for by insurance, constitutes a deductible loss. The amount of such loss is the difference between the cost of the flooring and furniture (or the fair market value on March 1, 1913, if acquired prior thereto, and such value was less than the cost), less depreciation sustained thereon, prior to the casualty, and the salvage value of the property. (B. 43-21-1885; O. D. 1076.)

The Treasury has held that when depreciation has not been an allowable deduction, as in the case of a taxpayer's residence, depreciation need not be considered in determining the gain or loss arising from the sale of the residence.[53] It would appear that the same principle should apply when determining losses in cases such as the one covered by the ruling immediately preceding.

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[53] See page 581.

Damages for personal injury.—

RULING. Plaintiff recovered damages on account of injuries sustained in a fall occasioned by reason of tripping over a wire stretched along the curb in front of defendant's residence.

Held, that the amount paid by the defendant does not constitute a loss from "other casualty" within the meaning of section 214 (a) 6 of the Revenue Act of 1918, and that he may not deduct it from his gross income for income tax purposes. (C. B. 4, page 155; O. D. 779.)

Accounting procedure.—Losses by fire, storm, etc., not compensated by insurance should be ascertained without delay and proper entries should be made therefor on the books. The law specifically permits the deduction of such losses "sustained during the year." This means the taxable year, fiscal or calendar, of the individual or corporation. If at the time of closing the books it is known that a loss has occurred and no adjustment has been made, the closing of the books should be deferred until an adjustment shall have been made, because the loss will not be an allowable deduction in the next period. If the delay is for a considerable time a tentative return can be made and later an amended final return can be substituted therefor.

RULING. When an insured loss occurs in one taxable year and the insurance is not recovered during that year the taxpayer should compute his loss by deducting from the total loss the estimated amount of the recoverable insurance. The loss so determined should be deducted from the taxpayer's gross income of the year in which the loss was sustained. If subsequent events demonstrate that this estimate was substantially incorrect, an amended return should be filed correcting the mistake. (C. B. 1, page 123; T. B. R. 55.)

Losses by theft and embezzlement.—Losses by theft[54] are

[54] **[Former Procedure]** The following ruling made in 1919 should be read in conjunction with Art. 146 of Reg. 62.

RULING. A loss incurred by a corporation through embezzlement is an allowable deduction from gross income for the year in which the embezzlement occurred. Where the embezzlement is not discovered in the taxable year but is later discovered and admitted by the embezzler, a part of the money being promptly recovered, the amount so recovered tends to diminish the amount of allowable deductions on account of the embezzle-

now specifically mentioned in the law among those which may be deducted."

If recent newspaper reports are trustworthy there will be many claims by individuals not in the liquor trade, for losses from theft of liquors. The regulations hold that such losses constitute allowable deductions. The basis of deduction is cost, not market value.

RULINGS. A loss incurred by a corporation through the embezzlement of securities held in bailment is an allowable deduction from gross income of the year in which the liability accrued, i. e., when demand was made by the bailors for the return of the securities and replacement thereof was made by the corporation. (C. B. 3, page 158; A. R. R. 269.)

A loss sustained by a corporation through burglary in 1917 is deductible in the taxpayer's return for that year only, although the question as to whether a burglary insurance company should repay all or any part of the loss to the company was not finally determined by the courts until 1919. (C. B. 4, page 143; A. R. R. 542.)

A forwarded to his brother B, $15x$ dollars to be used in the purchase of a bank. During the negotiations for the purchase, C absconded with the money. A expended x dollars as interest upon the sum lost, which was a loan, and x dollars in apprehending the thief. A's brother is unable to make good the loss and no recovery can be had from C.

Held, that A is entitled to deduct the amount of $15x$ dollars as a business loss and in addition the interest payment advanced to secure the loan. The amount expended in apprehending the thief, however, is regarded as a personal expense and may not, therefore, be deducted. (C. B. 3, page 156; O. D. 571.)

During 1916, A was induced by B, who represented himself as an agent of a manufacturing corporation, to invest $10x$ dollars,

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ment for the year in which the embezzlement occurred, and is ordinarily not returnable as income in the year when received. (C. B. 1, page 118; O. 845.)

[55] It is interesting to note that in England losses by embezzlement by an employee have only recently come to be recognized as allowable deductions.

"A loss by reason of embezzlement by an employee used to be looked upon as a loss by stratagem, and not one connected with, or arising out of, trade, and it used to be said that the amount could not be deducted. Such a loss, however, is now for income tax purposes deemed an expense of the year in which it is written off in the books." Murray and Carter, *Income Tax Practice*, page 281.

represented by two notes of $5x$ dollars each, in stock of the proposed corporation. A was to be made foreman of the proposed plant and the notes were to be paid by him out of the salary he was to receive from the corporation. B's representations were later found to be false and after discounting one of A's notes he absconded with the proceeds thereof, A having succeeded in recovering the other note. An investigation of the transaction was made in 1916 and it was then found that the parties who had put money into the enterprise would realize nothing from it. During 1917, A paid x dollars on the note discounted at the bank and renewed it for $4x$ dollars, which amount he paid in 1918, and claimed as a loss in computing his net income for that year. The question is raised as to the year in which the loss is properly deductible.

Assuming that A kept his books on a cash receipts and disbursements basis, it is held that he would not be in a position to deduct any loss until he had actually paid the note, thereby evidencing a completed and closed stock transaction. A may deduct the payments on the note in computing net income for the years in which such payments were made. The fact that the loss was discovered in 1916 is immaterial, because the date of discovery does not determine the date on which the loss was sustained. (I-3-32; I. T. 1167.)

Corporate Losses in Issuance and Redemption of Securities

Discount on bonds sold—a loss which may be prorated.— When a corporation sells bonds at less than par, it is because the nominal rate of interest as expressed in the bonds is less than the market rate. If a corporation has a high credit and there is a favorable market for securities, it will secure the advantage of a low rate of interest. Its 5 per cent bonds may sell at 110. If, however, the market is not so favorable, even though the credit of the company be unimpaired, its 5 per cent bonds may sell at 90. In both cases, if one assumes the credit of the company to remain constant, it is the market rate of interest current at the time which governs the price of the bonds. Proper accounting calls for a reflection of the actual interest cost spread evenly over the life of the bonds, and this is readily accomplished by adjusting the interest account.

The regulations which formerly considered such discounts as losses rather than interest, now provide that (except for

discounts on bonds purchased prior to 1909 and charged off) they may be prorated equitably over the life of the bonds.

Regulations. Discount on bonds issued and sold prior to the year 1909, if such discount was then charged against surplus or against the income of the year in which the bonds were sold, is held not to be deductible from the income of subsequent years, for the reason that the charging off prior to January 1, 1909, of the entire amount of the discount constitutes a closed transaction, and such transaction can not be reopened for the purpose of reducing the taxable income of a corporation for subsequent years by deducting therefrom an aliquot part of the discount. (*C. & A. R. R. v. U. S.*, Court of Claims; Reg. 33, 1918, Art. 149.)

(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. . . . .

(2) (*a*) If bonds are issued by a corporation at a premium, ... [and] (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. . . . .

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. . . . . (Art. 545.)

The foregoing follows very closely the language of article 544 of Regulations 45.

When bond discount has been capitalized at the time of issuance of the bonds (as was frequently done and approved by public service commissions not many years ago), and when such discount has not been otherwise amortized, it appears to

be permissible for income tax purposes to write off annually the *pro rata* amount.

When bond discount was charged to profit and loss during the year in which the bonds were issued (if since 1909), or during subsequent years, in amounts greater than the proper proportion, it seems to be permissible to prepare and submit amended returns for such years, or upon any reopening of a corporation's books by the Treasury to make claim for adjustment.

RULING. A corporation which issued its bonds at a discount and improperly charged the discount to profit and loss may correct its books to show the discount treated as interest paid in advance to be amortized over the life of the bonds. Amended returns reflecting correction in the books may be filed. (C. B. 1, page 224; O. D. 111.)

Decisions under the 1909 law.—The foregoing regulations are those prescribed by the Treasury under its authority to permit and require accounts to be kept on a basis which properly reflects the true net income of taxpayers.

Under the 1909 law the Treasury's hands were more or less tied. The law as written required accounts to be kept strictly on a cash receipt and payment basis. Therefore the decisions of the courts under the 1909 law are of interest only in connection with returns for periods prior to January 1, 1913.

BALDWIN LOCOMOTIVE CO. V. MCCOACH.—

RULING. The decision of the United States Circuit Court of Appeals for the Third Circuit, in the case of the *Baldwin Locomotive Works v. McCoach, Collector* (221 Fed. 59), holds that if the loss sustained by selling its own bonds at a discount is an expense of the business of a corporation, the expense will not be paid until the maturity of the bonds, and should therefore be prorated over the life of the bonds. (T. D. 2185, April 1, 1915.)

SOUTHERN PACIFIC R. R. CO. V. MUENTER.—

RULING. Where a corporation sold bonds at a discount during 1906, 1907 and 1908 no deduction from gross income for the years 1909, 1910 and 1911 of sums set aside by the corporation to pay such discount at the maturity of the bonds is permitted under

the provisions of section 38, Act of August 5, 1909, authorizing corporations to deduct from gross income "(second) all losses actually sustained within the year . . . ." and "(third) interest actually paid within the year on its bonded or other indebtedness. . . ." (260 Fed. 837.) (T. D. 2944, November 8, 1919.)

It will be noted that the court strictly construed the terms "losses actually sustained within the year" and "interest actually paid within the year."

Loss on bonds sold or paid at maturity.—When the amount received from the sale or redemption of bonds purchased prior to March 1, 1913, is less than cost, or fair market value March 1, 1913, (whichever was lower) the difference is an allowable deduction as a loss. If purchased on or after March 1, 1913, the deduction allowed is the difference between cost and the amount realized by sale or redemption.[56]

It should be remembered that there has been a great decline in the price of bonds since March 1, 1913, so that practically all bonds purchased or otherwise acquired prior to that time would show a loss if sold at this time.

REGULATION. . . . . If it (a corporation) retires its bonds at a price in excess of the issuing price, such excess may usually be deducted as expense. . . . . (Art. 563.)

If bonds were purchased at a discount or premium and the taxpayer has amortized the difference between par and purchase price, the amount of the loss is based on the book values and not on original cost, except as the value at March 1, 1913, may necessitate further adjustment.

RULING. Amortization of premium or discount on bonds as contemplated in articles 544, 563, and 848, Regulations 45, is not permissible in the case of the purchaser of bonds. The purchase price of the bond, even though different from par represents the investment. When the bonds mature or are sold the basis for determining the gain or loss is their purchase price, or their fair market value as at March 1, 1913, if acquired prior to that date. (C. B. 2, page 211; O. D. 475.)

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[56] Subject to modification by provisions of section 202 (a-2) of 1921 law as to property sold after December 31, 1920. This modification did not appear in the 1918 law.

The foregoing ruling is at variance with good accounting practice. A bank bought 7 per cent bonds at 110 in 1910. In 1920 the bonds were paid off at par. If all the premium had been amortized the books would show no loss in 1920, but under the ruling a loss could be claimed.

RULING. Where bonds mature serially, a proper proportion of the total discount and expenses should be allocated to each series and each series then treated as a separate unit. The deduction applicable to each series should be prorated equally over the life of the bonds constituting the series, provided, however, that if the corporation retired any of the bonds before maturity, the deduction for that year should be increased by an amount equivalent to the amount which would ordinarliy be deducted during the succeeding years on account of those particular bonds if they had not been prematurely retired. (C. B. 4, page 276; O. D. 936.)

Premium on capital stock redeemed not a deductible loss.—

RULING. This office is in receipt of your letter of the 6th instant, in which you ask for information on the following question: "A corporation in 1912 issued preferred stock for par. It was provided on the certificates that said stock was redeemable at 110. The company exercised its option and redeemed the stock at 110 by calling it in. The difference appeared on the books as a reduction of undivided profits. Is this difference a lawful deduction?"

In reply you are informed that this office will hold that the redeeming of the stock at a price in excess of par represents a capital transaction in which there can be no gain or loss to the corporation, and therefore the difference between the selling price of the stock and the price at which it was redeemed will not be deductible in a return of annual net income. (Letter to a subscriber of The Corporation Trust Co., signed by Deputy Commissioner ,G. E. Fletcher, and dated April 11, 1917.)

REGULATIONS. The proceeds from the original sale by a corporation of its shares of capital stock, whether such proceeds are in excess of or less than the par value of the stock issued, constitute the capital of the company. If the stock is sold at a premium, the premium is not income. . . . . (Art. 543. Reg. 45, Art. 542.)

A corporation sustains no deductible loss from the sale of its capital stock. . . . . (Art. 563.)

The purchase or redemption by a corporation of its own capital stock is an operation of a nature entirely different from

that involved in the retirement of bonds. The purchase or retirement of bonds at a premium involves a payment to a creditor. As explained above, the premium is nothing but a net expense spread over the life of the bonds. Payments to stockholders, on the other hand, must be out of profits (unless liquidation is in progress). Such payments are usually in the form of dividends, but in the numerous instances when corporations purchase their own shares at a premium, this premium in effect is a payment to a stockholder. Most states forbid a corporation to buy its own stock except out of surplus. Since the payment of a premium on shares is the equivalent of a dividend, there is no ground whatever for a claim that such premiums should be allowable deductions in an income tax return. In no sense of the word is such a payment capital. Although not an allowable deduction from net income, premiums on stock can be paid only from profits and that is the method always followed.

Consequently the author cannot agree with the Treasury when it says that the payment of the premium in redeeming stock is "a capital transaction in which there can be no gain or loss to the corporation." He does agree, however, with the conclusion that such payments are not deductible As such payments are not allowable deductions to the corporation, and must, therefore, be charged direct to surplus. it can be claimed that a distribution of profits, equivalent to a dividend, has been made. The corporation will have paid the normal income tax thereon and should notify its stockholders of that fact so that they may enter the receipt of the premiums as a dividend and thus avoid the normal tax.

Losses of Holding Companies—Accounting Procedure

The interests owned by holding companies in affiliated or subsidiary companies are usually represented by holdings of capital stock, bonds or other forms of indebtedness such as

promissory notes, open book accounts, etc. When a holding company desires to reflect on its books the profits or losses of its subsidiaries, it does so by the accrual and reserve method,[57] or by writing up or down the book valuations of the stocks or obligations owned.

Under existing rulings, a mere writing down of valuations is not an allowable deduction. But many transactions ordinarily reflected by a change in valuations are more properly recorded as "losses which are immediately deductible." If a subsidiary loses money and the holding company advances funds, which in effect are used to make good the deficit, and it is not likely that the subsidiary can repay the advance, it becomes a bad debt on the books of the holding company and should be charged off as a loss. The 1921 law specifically authorizes the Commissioner to allow a deduction for a bad debts reserve; when he is satisfied that a debt is recoverable only in part, he may allow it to be charged off in part.

Transactions of this kind are sometimes improperly handled. For example, the advance from the holding company to the subsidiary is often treated as a gift from one to the other. If this were really so, the holding company could not claim it as an allowable deduction (because gifts are not deductible); but in fact this is not a gift. It is on the part of the holding company one of the necessary expenses incurred in its business or a loss of similar nature. Holding companies are formed to make money. When they lose in transactions *from which profits were expected to arise*, it is a trade loss—not a gift in the nature of a beneficence or anything of that sort. Therefore at the time when such transactions are entered, the true state of affairs should be disclosed and inadvertent mention of a gift should be avoided.[58]

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[57] *Auditing, Theory and Practice* (3rd edition), by R. H. Montgomery, page 347 *et seq.*

[58] **[Former Procedure]** Article 115 of Regulations 33, 1918, required that earnings of subsidiaries taken up on the books of the holding company be returned as income. If the regulations were sound, then the converse must be good practice: that is, where *losses* of subsidiaries are taken up each month on the books of the holding com-

Decision. (Syl.) Where a railroad company upon being prohibited by State law from owning and operating docks and channels, organized a terminal company for that purpose, of which it owned all shares of stock except such as were necessary to qualify directors, and advanced as loans to it from year to year sums sufficient to cover its deficit, the railroad company may not deduct as operating expenses, in computing net income for the measure of the corporation excise tax imposed by the Act of August 5, 1909, the amount of such advances made during a taxable year.

Where interest on loans made by parent corporation to its subsidiary accrued from year to year, but was not paid, the amount thus accrued during a taxable year cannot be considered income to the parent company within the meaning of the Act of August 5, 1909. (*Walker v. Gulf and Interstate Ry. Co. of Texas*, 269 Fed. 885.)

The 1918 law provides for consolidated returns in all cases in which one corporation controls another or an individual controls two or more corporations. Therefore, when consolidated returns are made, the loss of one subsidiary operates as a credit against the profit of another and no adjustments need be made in the books.

It would not be wise, however, to depend on the desired adjustment being made through the medium of consolidated returns. State income tax returns will require accurate reports from subsidiaries and in many cases no report at all will be required from the parent company or an affiliated company.

Limitation on losses incurred in transactions outside business or trade.—Under the 1918 and 1921 laws all losses incurred in trade, or arising from transactions entered into for profit, are deductible, but under former laws there were limitations on the deductions.

For several years the author has contended that the Treasury did not properly interpret the earlier laws and that many losses which were disallowed were in fact allowable deductions. During 1919 a case was decided in a United States district court wherein the court held that the Treas-

pany, they could be claimed as allowable deductions. As the author questioned the soundness of the ruling as it affects income, the same criticism applies where there is a loss.

ury was in error in disallowing a loss which the taxpayer claimed as having been incurred in trade. The taxpayer received a large block of stock in an industrial company to whose affairs she evidently devoted some time and attention.

Decision. The transactions . . . . were complicated in character, involved a very large sum of money, and must have required much of her time and attention, and I am of the opinion that they were of the character contemplated by Congress as "incurred in trade." [*Bryce et al. v. Keith, Collector,* 257 Fed. 133 (March 26, 1919).]

Ruling. Where a corporation is authorized by its charter or certificate of incorporation to purchase stocks on a margin, and where there are no laws in the State where it trades in stocks making marginal stock transactions by corporations illegal, if it sustains a loss as a result of marginal trading in stocks, such loss may be deducted in computing its net income, if sustained during the taxable year and not compensated for by insurance or otherwise, unless it appears affirmatively that the transaction was merely colorable and no bona fide purchase of stock was made.

Where a corporation suffers losses as a result of its ultra vires act no deduction for such losses may be made in computing its net income. (C. B. 2, page 212; O. 968.)

"Relief" Provisions of the 1921 Law[59]

The radical changes expected in business conditions as a result of the cessation of the war made it seem imperative that losses arising from readjustments of inventories, which might occur within a few months thereafter, should be spread over a longer period of time. Similar conditions existed in the case of

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[59] [Former Procedure] Provision was made in the 1918 law [sections 214 (12-a) and 234 (14-a)] whereby losses resulting from a subsequent decline of a material amount in the value of the 1918 inventory, might be deducted from the net income of that taxable year and the tax be recomputed. An allowance for rebates was also permitted. A full discussion of this subject will be found in *Income Tax Procedure,* 1921, page 787 *et seq.* As a condition to the allowance of a claim under this provision, the Treasury illegally requires that the disposition of the entire inventory at the close of the 1918 taxable year be shown and that a net loss on the inventory must have been incurred. (Bulletin 30-21-1745; A. R. R. 544.)

For rulings dealing with rebates, see

Bulletin 31-21-1753; A. R. R. 590.
" 31-21-1754; A. R. R. 130.
" 42-21-1871; O. D. 1067.

losses arising from sales or depreciation of plant and equipment acquired for war purposes. To meet these difficulties the 1918 law provided certain so-called relief measures designed to assist in the re-establishment of normal conditions. Referring to these provisions Senator Simmons said:[60]

In addition to the relief amendments placed in the income tax title, but affecting profits taxes as well as income taxes, amendments relating to amortization and obsolescence, shrinkage in inventories, and so forth, the Senate added a general relief clause investing more or less discretion in the Commissioner of Internal Revenue and the Advisory Tax Board for relief in cases clearly establishing injustice, inequality or discrimination. The House conferees accepted these provisions of the Senate.

LAW. Section 204. . . . . **(b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary. . . . .**

There are two principal points of difference between the foregoing provision and the similar provision of the 1918 law:

1. The 1918 law permitted the application of the loss first against income of the preceding taxable year (involving a recomputation of the preceding year's tax and a refund of that previously paid) and the application against the following year's income of any excess of loss over income of the preceding year, whereas the 1921 law permits application of loss of one taxable year only against income of one or two succeeding years.

2. The net loss provision of the 1921 law is continuing in its character, whereas that in the 1918 law related only to net losses sustained in the years ended October 31, November 30 or December 31, respectively, of 1919.

It will be observed that neither the 1918 nor the 1921 law

[60] February 11, 1919, *Congressional Record*, page 3779.

makes any provision whatever for offsetting losses sustained in 1920 against the income of either preceding or succeeding years.

Definition of "net loss."—

LAW. Section 204. (a) That as used in this section the term "net loss" means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234,[61] as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost. . . . .

Section 204 does not apply unless a "net loss" has been sustained. When a taxpayer's profit and loss account shows a loss, as that term is commonly used, further consideration is essential in order to determine "net loss."

REGULATION. The term "net loss" as used in the statute means only a net loss resulting from the operation during the taxable year of any trade or business regularly carried on by the taxpayer. Included therein are losses from the sale or other disposition of real estate, machinery, and other capital assets used in the conduct of such trade or business. In order to be entitled to claim an allowance for a "net loss" the taxpayer must have suffered an actual net loss in a trade or business during the taxable year. The amount properly allowable may be neither the loss reflected upon the return filed for the purpose of the income tax nor the net loss shown by the taxpayer's profit and loss account, but is to be computed according to the statute, as follows.

[61] Providing for deductions allowed individuals (section 214) and corporations (section 234).

(1) In the case of an individual, it is the amount by which the deductions allowed under section 214, excluding:

(*a*) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gain or profits not derived from such trade or business;

(*b*) so much of the depletion deduction with respect to any mine, oil, or gas well as represents the excess of value based upon discovery subsequent to February 28, 1913, over cost or value as of March 1, 1913; and

(*c*) the amount of deductions allowed under section 214 not connected with the trade or business,

exceeds the sum of the following:

(*a*) the gross income of the taxpayer for the taxable year as computed under section 213; and

(*b*) the amount by which the interest received free from taxation under the provisions of the Act exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not allowed as a deduction under section 214 (a) (2).

(2) In the case of a corporation, it is the amount by which the deductions allowed under section 234, excluding:

(*a*) the amount received as dividends and allowed as a deduction under section 234 (a) (6); and

(*b*) so much of the depletion deduction with respect to any mine, oil or gas well as represents the excess of value based upon discovery subsequent to February 28, 1913, over cost or value as of March 1, 1913,

exceeds the sum of the following:

(*a*) the gross income of the taxpayer for the taxable year as computed under section 233; and

(*b*) the amount by which the interest received free from taxation under the provisions of the Act exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not allowed as a deduction under section 234 (a) (2).

In computing statutory "net loss" the following restrictions are to be noted:

(1) Interest received by the taxpayer on obligations or securities, the interest from which is exempted from taxation must be included in income, but this amount may first be reduced by the amount of any interest paid by the taxpayer on money used to purchase or carry such obligations or securities.

(2) Where depletion is computed upon the basis of discovery value in lieu of cost or value as of March 1, 1913, in making the computation, the deductions are reduced by that portion of the de-

pletion representing the excess of the discovery value over actual cost or value as of March 1, 1913. . . . . (Art. 1601.)

Computation of "net loss."—

The following official illustration is so clear that it needs no extended comment. The net losses to be carried forward are taxpayer's business losses. Therefore the statutory net loss as shown in the illustration agrees with the net loss shown by the taxpayer's books.

Taxpayers may have an apparent loss in 1921 which they hope will serve as an offset against net income in 1922 or 1923. But careful consideration must be given to what constitutes statutory net loss before they can be certain that the loss or any part thereof is a loss applicable against the income of succeeding years under the provisions of the law.

REGULATION. The method of computation of net losses as outlined in article 1601 may be illustrated as follows: A, an individual conducting a trade or business, finds the following facts relative to a taxable year;

(*a*) His deductions as computed under section 214 amount to $100,000.

(*b*) Included in the deduction is an item of $10,000 for loss by fire of property occupied by him as a residence and not used in connection with his trade or business.

(*c*) Deductible losses on account of transactions entered into for profit outside of the trade or business are $3,000.

(*d*) Taxable gains from transactions entered into for profit and not connected with the trade or business are $5,000.

(*e*) Donations to the Red Cross are included in the deductions in the amount of $1,000.

(*f*) Depletion is claimed in the amount of $2,000, of which $500 is based upon the value of the mineral in the mine as of March 1, 1913, and $1,500 is attributable to increase in valuation on account of discovery subsequent to February 28, 1913.

(*g*) His entire gross income as computed under section 213 is $50,000.

(*h*) Interest received from municipal bonds exempted from taxation by section 213 (b) (4) amounted to $10,000.

(*i*) Interest was paid upon money borrowed to carry municipal bonds in the amount of $8,000, which amount is not deductible in accordance with section 214 (a) (2):

Total deductions (*a*)			$100,000		
Deduct:					
Loss by fire (*b*)		$10,000			
Other losses (*c*)		3,000			
Total loss outside business		13,000			
Less: Gain outside business (*d*)		5,000			
Excess of deductible losses not sustained in trade or business over taxable gains or profits not derived from such trade or business		8,000			
Donations (*e*)		1,000			
Depletion on basis of value after discovery (*f*)	$2,000				
Less: Portion based on value as of March 1, 1913	500				
Portion of depletion representing discovery value in excess of cost or value as of March 1, 1913		1,500			
Total exclusion from deductions			10,500		
Total expenses directly attributable to the conduct of the trade or business				$89,500	
Gross income (*g*)			$ 50,000		
Add: Non-taxable interest received (*h*)		$10,000			
Less: Interest paid on money borrowed to carry municipal bonds (*i*)		8,000	2,000	52,000	
Statutory net loss					$37,500

(Art. 1605.)

"Net loss" of taxpayer having fiscal year.—

LAW. Section 204. . . . . **(d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.**

REGULATION. The provisions of section 204 relative to net losses are not retroactive and apply only to taxable years beginning after December 31, 1920, with the following exception: Where a taxpayer has a fiscal year beginning in 1920 and ending in 1921, if the taxpayer produces evidence showing to the satisfaction of the Commissioner that a "net loss" has been sustained during such fiscal year, the benefits of section 204 shall apply to the same proportion of such net loss as the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year. The net loss shall be first computed as prescribed in articles 1601 and 1605 for

the entire fiscal year ending in 1921 in accordance with this Act as in effect on January 1, 1921. The net loss allowable shall be the same proportion of the net loss for the entire fiscal year as the portion of the fiscal year falling within the calendar year 1921 is of the entire fiscal year. (Art. 1604.)

The foregoing provision merely extends a proportionate deduction to taxpayers whose fiscal years include only part of the year 1921.

Can net loss of period of less than twelve months be carried forward?—Section 204 (a), which provides for the carrying forward of net losses, mentions the period during which the loss occurs as "any taxable year beginning after December 31, 1920." Section 204 (d) provides that fiscal year concerns may carry forward that part of net losses which accrue after December 31, 1920.

Section 226 provides for returns for periods less than twelve months. Section 226 (a) deals with changes in fiscal periods and permits returns for less than twelve months. Section 226 (b) and (c) deal with the rates of tax and method of computation when returns are made for part of a taxable year. There is no specific provision in the 1921 law[62] which deals with carrying forward net losses when changes in fiscal years occurred during 1921 or which may occur thereafter. It is, however, clear that the intention of Congress is to extend the deduction in every case. There is no inhibition against the deduction when fiscal year changes result in returns for less than twelve months. Section 200 (1) provides that the

[62] **[Former Procedure]** The 1918 law (section 204) provided that losses in "any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920," might under certain conditions be applied to prior or subsequent periods. As the intention of Congress was clear to limit deductions to the period and dates mentioned, the provision has been strictly construed. The ruling of the Attorney General regarding this matter will be found in C. B. 3, page 83; T. D. 3044; see also Bulletin 30-21-1745; A. R. R. 554.

The Treasury has held that in order to be entitled to the benefits of section 204 of the 1918 law "The loss must be for a full taxable year (12 months)." (I-6-66; A. R. R. 743.)

For other rulings and comment see *Income Tax Procedure*, 1921, pages 784-787.

term "'taxable year' means the calendar year, or the fiscal year ending during such calendar year." Concerns starting business must select the calendar year or fiscal year basis.

This usually requires a first return covering less than twelve months. It would have been more satisfactory if section 200 (1) had specifically provided that in the case of new concerns and those changing fiscal periods the term "taxable year" should include the first return after starting business or after changing fiscal periods, but in view of the intention of Congress to extend the deduction to all taxpayers, there should be no discrimination against those whose first fiscal periods fortuitously are less than twelve months.

The provisions, or the intent, to tax for part of a fiscal period, even though it is not a taxable year, are broad enough to carry the implication that, if fully taxable for part of a period, taxpayers are fully entitled to the proportionate part of any benefits which apply to a "taxable year."

Section 204 (d) may be deemed to control the action of the Commissioner in extending the right to carry forward net losses even though the net loss period is less than twelve months. The case is not analogous to the procedure under the 1918 law, wherein the precise dates within which the loss was realized were prescribed. The reason for this was that the Armistice was signed on November 11, 1918, and net losses were applied to the period which it was assumed was specifically affected. The provision in the 1921 law is intended to apply to *all* net losses sustained after January 1, 1921.

Partnerships, beneficiaries and insurance companies allowed benefit of net loss provision.—

LAW. Section 204. . . . . **(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, and to insurance companies subject to the tax imposed by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary. . . . .**

In the case of a partnership the deduction would be available to the individual partners in the same proportion as the

partnership income is allocated to them.[63] A member, however, cannot segregate the net loss from other income and carry it forward independently. To receive the benefits of the provision a member of a partnership must sustain a loss after including his entire income from all business sources.[64]

Claim for net loss to be filed with succeeding year's return.—

Regulation. A taxpayer sustaining a "net loss" such as set forth in section 204, for any taxable year ending after December 31, 1920, may file a claim therefor with his return for the subsequent taxable year. Such claim should contain a concise statement setting forth the amount of the net loss and all pertinent facts relative thereto, including a schedule showing computation of the net loss in accordance with section 204 and articles 1601 and 1605 of these regulations. If the evidence furnished satisfies the Commissioner that the taxpayer has sustained a "net loss" the amount of such net loss may be deducted from the net income of the taxpayer for the succeeding taxable year and if such net loss is in excess of the net income for such succeeding taxable year the amount of such excess shall be carried over and credited against the net income for the succeeding taxable year. (Art. 1602.)

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[63] But see page 803.
[64] C. B. 2, page 58; O. D. 430.

[Former Procedure] The discussion of the limitation on losses under former laws is necessarily exhaustive and must be omitted from this volume. See *Income Tax Procedure*, 1920, pages 660-664. Also see previous editions. For Treasury rulings in 1920 and 1921, see:

C. B. 3, page 156; A. R. R. 242.
C. B. 3, page 317; A. R. M. 96.
Bulletin 44-21-1891; O. D. 1080.
Bulletin 43-21-1880; O. D. 1071.
C. B. 4, page 47; O. D. 932.
Bulletin 13-21-1528; A. R. R. 435.

CHAPTER XXX

DEDUCTIONS FOR BAD DEBTS

Two important changes are found in the 1921 law regarding bad debts. Taxpayers for the first time[1] may now deduct:

1. A reasonable addition to a reserve for bad debts.
2. Part of a debt which is not fully recoverable.

Taxpayers may continue on the old basis, i.e., they may deduct only those bad debts ascertained to be worthless and charged off during the year. This chapter will deal with the procedure to be followed when reserves are maintained, with the types of bad debts which may be fully deducted, and with the determination of the deductibility.

LAW. Section 214. [Individuals] **(a) That in computing net income there shall be allowed as deductions:**

(7) Debts ascertained to be worthless and charged off within the taxable year (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part. . . . .

The deduction for corporations [section 234 (a-5)] is exactly the same.

REGULATION. Bad debts may be treated in either of two ways—(1) by a deduction from income in respect of debts ascertained to be worthless in whole or in part, or (2) by a deduction from income of an addition to a reserve for bad debts. For the year 1921 taxpayers may, regardless of their previous practice, elect either of these two methods and will be required to continue the use in later years of the method so elected unless permission to change to the other method is granted by the Commissioner. . . . . (Art. 151.)

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[1] **[Former Procedure]** The 1913, 1916 and 1917 laws read: "debts due to the taxpayer actually ascertained to be worthless and charged off within the year." The change in the 1918 law was merely verbal.

The author has always contended that a reasonable addition to a reserve for bad debts was legal under 1918 and prior laws and should have been allowed. For full discussion, see *Income Tax Procedure*, 1921, pages 833-836.

Bad debt deductions for the taxable year 1921.—The following regulation aims first to place both classes of taxpayers, i.e., those who in prior years maintained reserves and those who did not, on the same basis.

REGULATION. Taxpayers who have, prior to 1921, maintained reserve accounts for bad debts may deduct a reasonable addition to such reserves in lieu of a deduction for specific bad-debt items. Taxpayers who have not heretofore maintained such reserve accounts may now elect to do so, and in such case shall proceed to determine the amount of the reserve that should reasonably have been set up as at December 31, 1920 (which shall not be deducted in computing net income), and in respect of 1921 and subsequent years may add a reasonable addition to such reserve and deduct the amount in computing taxable net income. . . . . (Art. 155.)

Taxpayers who did set up reserves in prior years presumably will have at the beginning of the taxable year 1921 a reserve for bad debts, the credits to which, when made, were not deducted in prior income tax returns. Therefore, when taxpayers who have not heretofore maintained reserves set up the proper reserve for bad debts at January 1, 1921, or the beginning of their fiscal years, they are not permitted to deduct the charge therefor from income. The proper charge is to surplus account. The adjustments which affect the income account should be made at the end of the taxable period.

REGULATION. . . . . Where a reserve account is maintained, debts ascertained after December 31, 1920, to be worthless in whole or in part, (*a*) if such debts were outstanding at December 31, 1920, should be charged against the reserve and may be deducted from income, in accordance with article 151; (*b*) if such debts arose after December 31, 1920, should be charged against the reserve, and not deducted from income. What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year. (Art. 155.)

The foregoing regulation permits in effect a double deduction for bad debts in the year 1921, viz.:

1. Accounts outstanding at December 31, 1920, which proved to be worthless in 1921.
2. Accounts arising from 1921 business which upon a reasonable estimate may be deemed to be bad.

In the years after 1921, only the addition (for the current year) to the reserve for bad debts is deductible. This might leave in the reserves amounts representing debts arising prior to January 1, 1921, which would never appear as allowable deductions. Taxpayers may reasonably assume, however, that uncollected debts which arose prior to 1921, and which could not be collected in 1921, are all bad at December 31, 1921.

Reserves for Bad Debts

It may be assumed that taxpayers in active business carry reserves for bad debts and that those who are not in active business do not.

Those who are not required under good accounting practice to keep books on an accrual basis are not affected by the 1921 law. When a debt is bad, it may be charged off. Taxpayers who do not keep books on an accrual basis should not ordinarily attempt to charge off only part of a debt.

When accounts are kept on an accrual basis, a reserve for bad debts is set up annually or oftener. For the taxable year 1921 the addition to the reserve may be claimed as a deduction.

The year 1921 is one of transition from the former practice of deducting from income only those debts ascertained to be worthless and charged off, to the new procedure of deducting from income the addition to a reserve for bad debts. Therefore, under the new procedure we must consider the deductibility of:

1. Debts ascertained to be bad in 1921 applying to sales of previous years.

2. Additions to a reserve for bad debts to include 1921 transactions.

Under the new regulations,[2] taxpayers may now deduct for the year 1921 the items in (1) as well as those in (2). Beginning in 1922, the deduction in the income account for the year as stated in the books of account and in the tax returns will agree for the first time since 1913.

Accounting procedure.—When taxpayers have not maintained reserves for bad debts and desire now to conform to good accounting practice and the regulations, the following procedure is suggested:

1. Set up a reserve for bad debts before closing the books as of December 31, 1921, which is to be credited with:

   (a) The amount of the reserve which should have been set up December 31, 1920.

   (b) An allowance for uncollectible accounts arising from the business of 1921, based on the same percentage of the 1921 charge sales which the uncollectible accounts were of the charge sales for the previous three or five years.[3]

2. Charge against the reserve suggested above all the accounts determined to be uncollectible and charged off during 1921:

   (a) The aggregate of accounts accrued prior to January 1, 1921.

   (b) The aggregate of accounts accrued during 1921.

3. The allowable deduction for bad debts in 1921 returns

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[2] T. D. 3262 (issued December 21, 1921) did not permit the deduction of both items in (a) and (b). It is assumed that as Art. 155 of Reg. 62 (see page 1031) appeared after T. D. 3262 and before any returns for 1921 were made, T. D. 3262 should be wholly ignored.

[3] This allowance must be adequate to provide for (a) the losses which experience indicates will probably be sustained on accounts arising from 1921 sales which are uncollected at December 31, 1921, and (b) any accounts for 1921 sales which were determined to be uncollectible and written off on or before December 31, 1921.

is 2 (a) plus 1 (b). For subsequent years the deduction is 1 (b) for the current year. When taxpayers have maintained reserves in prior years, the deduction for income tax purposes is exactly the same as outlined above.

At the end of each year after 1921 there would be credited to the reserve simply a percentage on the charge sales of the year; all accounts finally decided within the year to be uncollectible would be written off against the reserve plus specific extraordinary items, in whole or in part, which are not included in the normal percentage. After 1921 it would not be necessary to distinguish as to the year's sales from which the written-off accounts arose.

The 1921 law provides that debts that are bad "in part" may be deducted, and the new regulations state that: "Partial deductions will be allowed with respect to specific debts only."

At the end of each year the balance in the reserve account naturally will have to be reviewed for the purpose of determining whether the percentage used in computing the credit to the reserve for the year is adequate or whether it may be either too high or too low, in view of more recent experience. The percentage will, of course, need to be modified to whatever extent additional experience indicates to be necessary.

From the foregoing it is apparent that taxpayers who have not heretofore maintained reserves for bad debts should immediately adopt the reserve basis. In effect, they will secure a double deduction for 1921. Taxpayers already maintaining reserves will secure a like benefit.

Effect on invested capital of establishing reserve for bad debts at beginning of 1921.—Taxpayers who previously have not maintained reserves, if electing the reserve method, must set up "the reserve that should reasonably have been set up as at December 31, 1920 (which shall not be deducted in computing net income)." The charge will be to surplus. The reserve may be included as invested capital from the beginning of the year, even though the amount of such reserve will be de-

ducted in effect from 1921 income through charging to such reserve during 1921 those accounts outstanding at the beginning of the year which prove in 1921 to be bad. Such bad debts, under article 155,[4] may be deducted from 1921 income. The reserve at the beginning of the year is regarded as segregated surplus. The charges against such reserve affect the 1921 income and therefore do not serve to reduce invested capital for 1921.

Again, the reserve set up at the beginning of 1921 will not be deducted from accounts receivable in computing admissible assets, which means that the percentage of inadmissibles will be smaller.[5]

Only Bona Fide Debts Deductible

If an item claimed as a bad debt partakes of the nature of a gift more than of that of a loan, or if, arising during a period when it could or should have been reported, it has not been included in the federal tax reports as gross income, it is not deductible as a bad debt.

Loans to friends or relatives.—A question in the *Income Tax Primer* reads as follows:

Ruling. If, on account of friendship or relationship I advanced a certain sum to assist a needy friend or relative, and at the time such advance was made I had little or no reason to expect that the amount so advanced would ever be returned, may I now claim a deduction to cover such advance?

No. Such an advance, partaking, as it does, somewhat of the nature of a philanthropic donation or a goodwill offering, is not held to constitute a bona fide debt. (*Income Tax Primer*, 1918, question 94.)

Where the element of gift is absent, the Treasury permits the deduction.

Ruling. A certain taxpayer was notified by his bank that a note

[4] See page 1031.

[5] For discussion of the treatment of reserves for bad debts in respect to inadmissible assets, see Chapter IX of Appendix A.

had gone to protest and that he, as one of the indorsers, was liable for the payment thereof. In order to defend a relative who had forged the indorsement, the taxpayer gave the bank another note of the same face value. The taxpayer made arrangements with his relative whereby the relative was to pay the amount of the note on the installment plan. The relative, however, made no payments in the year 1919 and payment could not be enforced since he had no assets. During that year the taxpayer paid the note in full to the bank and deducted as a bad debt for the year 1919 the difference between the amount paid the bank and the amount by which he had been reimbursed by his relative.

Held, that the amount deducted is allowable since it represented a debt due from the relative and not a gift to him. (C. B. 4, page 173; O. D. 934.)

Income corresponding to bad debt must have been reported in tax returns.—

Regulation. Worthless debts arising from unpaid wages, salaries, rents, and similar items of taxable income will not be allowed as a deduction unless the income such items represent has been included in the return of income for the year in which the deduction as a bad debt is sought to be made or in a previous year. . . . . (Art. 152.)

This regulation applies particularly to taxpayers who have rendered returns based on cash receipts and payments. It is well illustrated by the following quotation from the *Income Tax Primer:*

Ruling. A professional man earned a fee in 1916. As he keeps no books, he reports his income for tax purposes on an actual receipt basis. As this fee has never been reported as income, can it be claimed as a deduction if collection can not be made?

No; never having been returned as income it can not be claimed as a deduction. (*Income Tax Primer,* 1918, question 96.)

It must be understood, however, that the rulings quoted do not debar one from claiming the deduction of an item as a bad debt, even though the corresponding income has not been reported, in case the account arose before the federal income tax laws were in force. The effective date for corporations, under the excise tax law, is January 1, 1909, and for individuals, under the general income tax law, it is March

1, 1913. Debts existing and carried as good on these dates may be treated as allowable deductions if subsequently found to be uncollectible. The entire amount may be deducted in the return of the year during which the debt was found to be bad.

Special Types of Bad Debts—How Valued

Bankruptcy claim—extent to which deductible.—

REGULATION. . . . . Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted as a bad debt.

Claims against decedent's estate—extent to which deductible.—

The difference between the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate and the amount of his claim may be considered a worthless debt. . . . . (Art. 152.)

Debt ascertained to be bad after decedent's death.—

RULING. The amount paid by the administrator as the decedent's share of a note upon which he was a coindorser, which amount was not determined at the time of the decedent's death, is not deductible in the return for the decedent, but is deductible by the administrator, if the debt is uncollectible, in his return for the estate for the taxable year in which it was paid and charged off on his books.

The difference between the amount paid by the administrator in taking up paper indorsed by the decedent and the appraised value of the claim subrogated to the administrator is not deductible by the administrator until the claim has been disposed of and the transaction is closed and completed. (C. B. 2, page 137; O. D. 556.)

Accounts receivable purchased—basis for deduction.—

REGULATION. . . . . A purchaser of accounts receivable which can not be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of deduction to be based upon the price he paid for them and not upon their face value. (Art. 152.)

Notes receivable—basis for deduction.—

REGULATION. . . . . If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair mar-

ket value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation. . . . . (Art. 151.)

The entry of notes at less than their face value is equivalent to the creation of a reserve for bad debts. The Treasury denied the privilege to taxpayers evidently when it was not their "practice" to take up the notes at market value.

RULING. When a merchant has notes receivable for goods sold and grants the purchaser an extension of time within which to pay the notes, the Bureau is without authority to permit him to treat the fair market value of the notes as the price for which the goods were sold or to deduct from gross income as a loss the difference between the face value of the notes and their fair market value at the time they originally became due. (B. Digest 30-21-1742; O. D. 979.)

The 1921 law takes care of the foregoing situation, as the notes evidently were bad in part.[6]

REGULATION. Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the value of the bonds on March 1, 1913. Bonds purchased since February 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount actually paid for them.[7] Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. . . . . (Art. 154.)

A new provision is found in article 154 of Regulations 62, permitting taxpayers to deduct part of the cost of bonds when it can be shown that the holder will recover a smaller amount. This is in accordance with the statute, which permits "part" of a debt to be deducted. Bonds of traction companies whose hope of revival is small are examples.

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[6] See page 1030.

[7] Reg. 45, Art. 154 (1919 edition), read: "but not exceeding their amortized value if purchased at a premium." Since the Treasury did not permit the premium on bonds purchased to be amortized, the limitation was unnecessary. (B. 17-20-887; O. D. 475.)

REGULATION. . . . . A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. Where a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations and is able to so demonstrate to the satisfaction of the commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations. (Art. 154.)

Debts held prior to March 1, 1913—basis for deduction.—

REGULATION. . . . To authorize a deduction for a bad debt on account of notes held prior to March 1, 1913, their value on that date must be established.[8] (Art. 154.)

Obviously if a taxpayer in 1921 charged off a debt which had been carried as good since March 1, 1913, it would be reasonable to inquire whether or not on that date the debt was deemed to be good. But the mere fact that on that date there was some doubt as to its value would not mean that the deduction was an improper one in 1921. Until the passage of the 1921 law, the Treasury always held that no debt could be charged off until it was 100 per cent bad. Subsequent transactions with a debtor would indicate *prima facie* that the debt was collectible at March 1, 1913.

Debts Must Be Actually Ascertained to be Worthless in Whole or in Part

The law specifies that a debt to be deductible as bad must be "ascertained to be worthless" [section 214 (a-7)], and it also specifies that "the Commissioner may allow such debt to be charged off in part."

[8] **[Former Procedure]**
REGULATION. "All debts representing amounts that became due and payable prior to March 1, 1913, and not ascertained to be worthless prior to that date, whether representing income or a return of capital, are held to be allowable deductions, under paragraph B of the law, in a return of income for the year in which they are actually ascertained to be worthless and are charged off." (T. D. 2224, July 13, 1915.)

When is a debt worthless?—In describing the deductions permitted to individuals the regulations set up the following general standards.

DEBTS ENTIRELY WORTHLESS.—

REGULATIONS.[9] . . . . Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. . . . . (Art. 151.)

DEBTS PARTLY WORTHLESS.[10]—

REGULATIONS. . . . . Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is charged down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. . . . . In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only. . . . . (Art. 151.)

If part of a debt was ascertained to be worthless and was charged off prior to 1921, the Treasury under previous practice would not allow the deduction. The entire amount had to be worthless and be charged off. It appears that the Treasury will not now allow the partial write-off, previously denied,

[9] **[Former Procedure]** The following sentence in Reg. 45, Art. 151, which does not appear in Reg. 62, indicates former procedure: "An account merely written down . . . . is not deductible."

[10] **[Former Procedure]** For rulings when compositions and other settlements were made, see *Income Tax Procedure*, 1921, pages 829-831.

to be deducted in the return until the entire amount of such debt is ascertained to be totally worthless.

For example, if an account for $1,000 was written down to $600 in 1920, the $400 deduction was disallowed if claimed in the 1920 return. It would, however, form part of the reserve set up as of January 1, 1921, and if not collected by December 31, 1921, the entire $1,000 would no doubt be deductible in 1921.

When debtor corporation becomes insolvent.—The statements in the foregoing regulation are couched in terms broad enough to include all debts due the individual whether from corporations or from other individuals.

Ruling. An insolvent corporation was heavily indebted to A, its majority stockholder. A agreed to take as payment of the company's indebtedness to him, the free assets of the company and to assume its liabilities other than its bonded indebtedness. This transaction is considered a cancellation of the debt due to A and any loss sustained by him is deductible only in the return for the year when the transaction took place, and not when the assets were disposed of subsequently. The measure of the loss would be the difference between the liabilities assumed including the debt to himself, and the value of the assets at the time received by A. (C. B. 2, page 138; A. R. R. 30.)

In the following ruling the solvency of the corporation was in doubt. Under the 1921 law, in such cases taxpayers would be justified in charging off the debt in part.

Ruling. In 1917, A loaned to a corporation $10x$ dollars, taking a note secured by a mortgage upon real estate against which there were two prior mortgages, and in his 1918 return he deducted this indebtedness as a bad debt and the question is raised as to the justification of the deduction. The debtor held at the end of 1918 this property, said to have been worth $75x$ dollars, which value was established by an appraisal made by B, a disinterested person, who later purchased the property. A second property held by the debtor at the end of 1918, consisted of land of the value of $7x$ dollars, which property was held by the corporation as late as June, 1920. Against these two properties, having a combined value of $82x$ dollars, there rested at the end of 1918 a total indebtedness of $71x$ dollars (of which $53x$ dollars consisted of mortgages prior to A's), leaving the net worth of

the corporation 11*x* dollars. The corporation was a going concern at the end of 1918.

Held, that A, under the circumstances, was not justified in claiming that the entire debt was worthless at the close of 1918, nor that a substantial part thereof would not be recovered, though from his knowledge of conditions as they existed at the end of 1918, he was undoubtedly justified in believing that, should foreclosure occur, his loan of 10*x* dollars would result in a loss. (C. B. 4, page 172; A. R. R. 365.)

If soon after the close of 1918, A's judgment of the worthlessness of the debt was verified, the subsequent event would be affirmative evidence that the deduction in 1918 was proper.

Loss due to seizure of property by Russian Soviet government.—

RULINGS. A in 1916 and 1917 purchased through a New York bank certain credits in two Russian banks. Subsequently A made several efforts to communicate with these banks but without success, and the New York bank is unofficially informed that these particular banks were taken over in the latter part of 1917 by the Russian Federated Soviet Republic and their assets dissipated, confused, and destroyed. The taxpayer has claimed the amounts paid for these credits as a loss in his return for 1918.

The Committee is of opinion from what is a matter of common knowledge, and from the statement made as to the endeavor to communicate with the debtors and the information received as to the banks' practical abandonment of their business, that the taxpayer was justified in charging off these credits in 1918 as a total loss. (C. B. 3, page 165; A. R. M. 64.)

Bank deposits in Russian banks can not be considered as worthless for the purpose of claiming a deductible loss in a return for the taxable year 1919. The Bureau is informed that Russian rubles in the form of bank deposits were sold during the latter months of 1919, which would indicate that they were not at that time worthless. (C. B. 2, page 137; O. D. 535.)

In order that a taxpayer may claim as a deduction Russian rubles owned by him and deposited in a Russian bank, it is necessary for him to submit evidence establishing the fact that the bank in which the deposits were made has lost its identity as a banking institution or that it has been taken over by the Soviet Government and its funds requisitioned, confiscated, or dissipated. (C. B. 4, page 173; O. D. 923.)

Accounts uncollectible because of moratorium in Cuba.—

RULING. As a result of the moratorium in Cuba certain accounts due from customers there were uncollectible at the close of the taxable year 1920. Held, that these accounts can not be deducted as bad debts until it has been definitely ascertained that they are worthless and are charged off the books. (C. B. 4, page 173; O. D. 891.)

Under the 1921 law taxpayers may make a reasonable estimate of the amount uncollectible in such a case and deduct such amount from income. The loss claimed must be determined with respect to each account separately.

Depreciation of collateral security.—When a debtor who has put up collateral is known to be unable to pay and the collateral security is worth substantially less than the amount of the debt, there is no good reason why the taxpayer should be compelled to sell the collateral, or make a "wash" sale of it, in order to charge off the loss which has been sustained.

It is clear, under the 1921 law, than an accrued loss of 50 per cent of a debt, when determined by recognized methods of accounting, is as deductible as a loss of 100 per cent.[11]

Bankruptcy as a test.—

REGULATION. . . . . Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Actual determination of worthlessness in bankruptcy cases is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had.[12] Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deduction to such later year. In the case of debts existing prior to March 1, 1913, only

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[11] See also C. B. 3, page 167; A. R. R. 352.

[12] **[Former Procedure]** Article 8 of Regulations 33, 1918, stated that the "determination of worthlessness in such cases is possible only when settlement in bankruptcy shall have been had."

Article 151, Reg. 45, read: "Bankruptcy may or may not be an indication of the worthlessness of a debt."

their value on that date may be deducted upon subsequently ascertaining them to be worthless. . . . . (Art. 151.)

The new regulation distinguishes "unsecured and unpreferred debts" from others, indicating that in practically all cases of bankruptcy there may immediately be charged off at least a part of "unsecured or unpreferred debts."

Foreclosure sale on a mortgage.[13]—

Regulation. Where mortgaged or pledged property is lawfully sold (whether to the creditor or other purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. Where a taxpayer buys in mortgaged or pledged property for the amount of the debt, no deduction shall be allowed for any part of the debt. Gain or loss is realized when the property bought in is sold or disposed of.

Accrued interest may be included as part of the deduction only when it has previously been returned as income. (Art. 153.)

The foregoing regulation recognizes that the purchase of mortgaged property by the mortgagee for less than principal and accrued interest, demonstrates that the debt is bad "in part" and such "part" may be deducted.

The Treasury has held that upon foreclosure, when the proceeds were sufficient only to satisfy the first mortgage,

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[13] **[Former Procedure]**

Regulation. "Where under foreclosure a mortgagee buys in the mortgaged property and credits the indebtedness with the purchase price, the difference between the purchase price and the indebtedness will not be allowable as a deduction for a bad debt, for the property which was security for the debt stands in the place of the debt. The determination of loss in such a situation is deferred until the property is disposed of, except where a purchase money mortgage is foreclosed by the vendor of the property. . . . Only where a purchaser for less than the debt is another than the mortgagee may the difference between the debt and the net proceeds from the sale be deducted as a bad debt." (Reg. 45, Art. 153.)

T. D. 3264 and 3265 (both dated December 21, 1921) amended the regulations under the 1918 and 1917 laws, respectively, to read in accordance with Reg. 62, Art. 153, quoted above.

the amount of the second mortgage may be charged off if action against the mortgagor would be useless.[14]

When a creditor bids up to the amount of his claim when property is offered for sale, it is *prima facie* evidence of its value, and the regulation is in order. But if it can be shown that the property acquired is not worth the amount of the claim, and that the bid was merely formal, the law permits the deduction of any part of the debt which is bad.

Recoveries.—In some cases debts presumably "definitely ascertained to be worthless" have unexpectedly proved to be collectible in whole or in part. The following regulations provide for the taxation of such collections.

REGULATIONS. . . . . Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. . . . . (Art. 51.)

. . . . Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off, and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. . . . . (Art. 151.)

If collections are made from accounts charged off prior to March 1, 1913, it may be assumed that on that date there was due *at least* as much as the amount collected, exclusive of interest. Therefore there can be no element of taxable income in such recoveries except as to interest accrued after March 1, 1913. The requirement that recoveries from accounts arising out of transactions since March 1, 1913, be included in current income instead of reopening the accounts and returns of prior years, is reasonable.

Loss of endorser or guarantor—when determined.—Upon the failure of the maker of a note to take it up at maturity, the endorser may have to pay and thereupon a debt due to the

[14] Bulletin 42-20-1244; O. D. 687.

endorser arises. Strictly speaking, it may not be "ascertained to be worthless" immediately, but everyone knows that ordinarily the chances are at least 99 to 1 that it will be a bad debt and usually it takes very little time to reach this conclusion. After allowing a reasonable time in which to ascertain why the maker does not make good, the endorser should charge it off as a bad debt, taking credit for it in his return.

The right to deduct the bad debt is governed by the regulations cited. There is no requirement that the obligation to pay a note as endorser or guarantor shall have arisen from business or trade, so that the restrictions of past years as to losses would not apply in any case.

Ruling. Where a person purchases bonds for another, guaranteeing said bonds against any loss, and a loss occurs due to subsequent insolvency of the corporation issuing same, and the guarantor makes good the loss, the same is not deductible within the meaning of section 214, article 141, of the Revenue Act of 1918, unless such loss occurs in trade or business or in a transaction entered into for profit. (C. B. 1, page 125; O. D. 241.)

The author does not agree with the foregoing ruling. It is difficult at times to distinguish between a bad debt and a loss, but when a debt to the taxpayer is created and the debt becomes bad, the law permits a deduction therefor in all cases.

Liability as endorser at March 1, 1913.—

Ruling. The records in the case show that in the year 190– and subsequent thereto, A indorsed certain notes issued by the M Company and also certain notes issued by the N Company, which companies became insolvent prior to March 1, 1913, and A thereupon became liable as indorser for payment of said notes, since which time he has made certain payments of principal and interest.

. . . . it appears clear that A has never become primarily liable for payment of the principal of the said notes or the interest thereon, nor has he ever given any written agreement to make such payment. As the original notes became due they were renewed, in the names of the original makers and were indorsed by A. Had the latter, upon default in payment of the notes prior to March 1, 1913, then given his own note or notes in payment, a debt would have been created upon his part which would have precluded the allowance of deductions claimed to cover payments made in liquidation of his own notes,

inasmuch as payments made in liquidation of an indebtedness created prior to March 1, 1913, can not, under the provisions of any income tax law enacted since that date, be allowed as deductions.

In the opinion of the Committee, A suffered no actual loss through his indorsement of the said notes until he made his first payment in liquidation of their principal and interest thereon. When a payment was made it created a debt in his favor due from the makers of the notes, which debt was at the time it was so created definitely known to be worthless and uncollectible. Each additional payment created an additional bad debt.

In view of the foregoing the Committee recommends that the action of the Income Tax Unit in disallowing the deductions claimed by A for the years 1917, 1918, and 1919 to cover amounts paid in liquidation of the said notes and interest thereon be reversed, and that the said deductions be allowed in the amounts as claimed. (B. 38-21-1837; A. R. R. 479.)

The reasoning in the foregoing ruling would apply to transactions after March 1, 1913, as well, and enable taxpayers to take a deduction as payments are made on the theory that each payment "creates" a debt from the maker, which is known to be worthless.

Bad debts of banks and other corporations, under government supervision.—A new provision is found in the regulations under the 1921 law, as follows:

Regulation. . . . . Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders, or in accordance with the general policy of such supervisory officers, charge off debts in whole or in part such debts shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed, for income-tax purposes, to be worthless or recoverable only in part, as the case may be. (Art. 151.)

Illegal warrants received by bank.—

Ruling. A bank received illegal warrants from the auditor of a political subdivision of a State in payment of promissory notes which it held against the auditor and the treasurer. The treasurer made payment of the warrants by checks drawn on an account of the subdivision at the bank. In compromise of the claim of the subdivision for the money misappropriated the bank paid x dollars, which amount it set up as a claim against the officials in a special account of bills

receivable. The bank brought suit against the ex-officials, and several years later, in 1919, final judgment against the bank was rendered. Upon the rendition of the judgment, the bank in 1919 charged off a portion of the debt and carried the remainder in the profit and loss account as a debit balance.

Held, that the entire amount actually lost by the bank is deductible as a bad debt in 1919.

Held also, that the court costs, attorney's fees, and other expenses incurred in attempting to collect the amount paid under the compromise agreement are proper deductions from the income of the year in which such expenses were incurred. (B. Digest 27-21-1713; O. D. 965.)

Debts Must Be Charged Off Within the Year

Charging off bad debts.—The 1921 law requires in the case of individuals and corporations that bad debts must be charged off within the taxable year.[15] These words would seem to require that actual book entries be made by both corporations and individuals in case they desire to claim deductions for bad debts. However, the answer to question 90 of the *Income Tax Primer* interpreting the 1917 law which used the same phrase in describing the conditions which are necessary to claim a debt as a deduction reads: "*If books are kept* it must be charged off within the year," plainly inferring that it is still deductible when no books at all are kept.

"Within the year."—The phrase "within the year" refers to "the year for which the return is made."[16] To be deductible the debts must be charged off or included in a reserve which is charged off.

In the case of corporations, deductions for bad debts prior to the 1918 law were classified as business losses and these, it will be recalled, had to be "actually sustained and charged off within the year." [1917 law, section 12 (a) second.]

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[15] [Former Procedure] The 1913, 1916, 1917 and 1918 laws all contained a similar requirement.

[16] Reg. 33, 1918, Art. 151.

The term "within the taxable year" should be construed in an accounting sense, that is, if books of account are closed as of December 31 and an entry written in the books during January is dated December 31, the entry is deemed to have been made within the year ended December 31.

CHAPTER XXXI

DEDUCTIONS FOR DEPRECIATION

Depreciation is a decline in the value of property such as may reasonably be expected to occur as a result of wear and tear and gradual obsolescence. It is due to the possession and use of assets, and therefore is a part of the cost of operation. P. D. Leake defines it as "expired outlay upon productive plant." The phrase "accrued renewals" sometimes used to describe depreciation is illuminating. It is to be noted that depreciation is usually treated as a comprehensive term which includes all declines of the nature described above.

The Treasury's definition is:

Ruling. Depreciation means the gradual reduction in the value of property due to physical deterioration, exhaustion, wear and tear through use in trade or business. (Bulletin "F," page 5.)

The 1921 law does not use the word "depreciation" at all in describing the deduction permitted under this head.

Law. Section 214 (a-8) [Individuals]; Section 234 (a-7) [Corporations]. **That in computing net income there shall be allowed as deductions:**

A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business,[1] including a reasonable allowance for obsolescence. In the case of such property acquired before March

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[1] **[Former Procedure]** 1913 law. (Individuals) Section II B. Sixth. "A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business."

(Corporations) Section II G (b). "A reasonable allowance for depreciation by use, wear and tear of property, if any."

1916 law. (Individuals) The words "or trade" were added.

(Corporations) The words "actually sustained and charged off" were inserted.

The 1917 law made no change.

1918 law. Section 214 (a-8). A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

Section 234 (a-7) for corporations reads exactly the same as for individuals.

1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

The last sentence quoted above was added in the 1921 law.

LAW. Section 215 **(a) That in computing net income no deduction shall in any case be allowed in respect of—**

[Individuals] **(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; . . . .**

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;[2] . . . .

The limitation on deductions by corporations (section 235) is the same as for individuals stated in section 215 quoted above.

In the regulations of the Treasury depreciation "applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the property becoming inadequate to the growing needs of the business."[3] What may be termed ordinary obsolescence will be discussed in this chapter. Separate chapters in this book are devoted to extraordinary obsolescence and to depletion.[4] It will be clear from the context whether depreciation is used in the inclusive or in the restricted sense.

Depreciation is often treated as though no accurate estimate of the life of assets were possible, with the result that in some cases excessive reserves are created and in other cases there are no reserves at all. Perhaps the controlling reason for this variation of practice is a desire to utilize this as an elastic factor to bring about a desired effect on the balance sheet and the profit and loss statement. In some cases it is also felt

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[2] Subsections (2) and (3) are substantially the same as in the 1913, 1916, 1917 and 1918 laws.

[3] Art. 162, Reg. 62. Art. 159 of Reg. 33, 1918, differentiated depreciation from "depletion, obsolescence and other losses."

[4] See Chapter XXXII, "Deductions for Obsolescence," and Chapter XXXIII, "Deductions for Depletion."

that excessive book valuations may favorably affect the insurance adjustment in case of fire, but this fallacy is gradually losing ground. The recent improvement in methods of allowing for depreciation can be traced in large part to the installation of cost systems, which have brought about an increasing recognition of this factor as a necessary cost of production. Another powerful influence in the direction of accurate and adequate reserves has been the enactment of federal and state income and other tax laws calling for returns of net profits. Altogether there has in recent years been a general awakening to the fact that depreciation is a vital issue in correct accounting.

There are still wide differences of opinion as to the amount of the allowance which should be made from time to time. Net profit means only one thing in the vocabulary of the professional auditor—a meaning which should be universally recognized—and that is the excess of income over operating costs, expenses and losses. It cannot be determined by taking into account all the income and a part only of the charges against income. Full provision for depreciation must be included among the costs of operation, or the result may not be accepted as representing net profit. Statements, sometimes encountered in published reports, to the effect that a corporation has realized net profits amounting to a certain sum and that out of these profits an allowance for depreciation has been made are both misleading and illogical.

It is an unfortunate fact that the efforts of accountants to secure the establishment of proper depreciation reserves have in some respects been retarded and hampered by the attitude of certain inspectors in the administration of the income tax law. Part of the difficulty has been due to a mistaken general policy on the part of the government in favor of strict limitations on depreciation. In the first place, reserves for this purpose, if found in the future to be too large, will be ultimately taxable for any excess, and, in any case, the government cannot afford in the long run to ignore sound

economic principles in determining net income. Perhaps the greatest share of the trouble is due to the action of incompetent inspectors who sometimes arbitrarily insist upon a reduction of reserves to insufficient amounts. Fortunately their action is rarely sustained by the officers of the Treasury, whose recent attitude in the matter of depreciation and depletion has been in accord with good accounting practice.

Applicability of rates of depreciation used in prior years.—Taxpayers who use substantial rates of depreciation have sometimes been embarrassed by examiners who applied the rates used in 1917 and 1918 to their plant accounts for many years prior. In some cases this application of the rates practically wiped out the plant account as at January 1, 1917, (except for the additions of the years immediately preceding) and thus greatly reduced the allowable invested capital for excess and war profits purposes.

Such a method, of course, is inaccurate and falls of its own weight. In most cases it is possible to prove that on January 1, 1917, the actual value of the plant, without taking appreciation into consideration, greatly exceeded the theoretical valuation. Such result does not in itself prove that because the rates are incorrect as applied to prior years they are also incorrect as applied to 1917 and 1918.

The rates are incorrect as applied to prior years because during those years the renewals, repairs, maintenance and capital outlays charged to operations greatly reduced the reserve necessary to reflect accurately the net going value of the plant on the books of account.

One concern charging high depreciation rates for 20 years prior to 1917 might show the same net plant values at the end of the period as a concern which charged off no depreciation, as such, during the entire period.

The *La Belle Iron Works* decision[5] clearly holds that tax-

[5] 41 Sup. Ct. 528.

payer's actual investment at January 1, 1917, is the proper measure of invested capital, irrespective of book entries.

During the past year the Treasury has recognized that the practice of examiners in revising depreciation allowances set up on taxpayer's books or of making purely theoretical allowances where specific depreciation allowances had not formerly been set up as such in the taxpayer's accounts, was an improper act, and that the plant values at January 1, 1917, should, with respect to depreciation accrued prior to that date, be accepted as they appear in the taxpayer's books unless the revenue agents can produce affirmative evidence that the book values of plant are in excess of their actual value at the beginning of the taxable year. The full text of the memoranda published by the Treasury on this subject appears in Chapter VIII of Appendix A. Prior to the enactment of the 1917 law, it made little difference to many concerns, from a tax point of view, what rates of depreciation were charged. Furthermore, during 1917 and 1918 there were good reasons for greatly increasing depreciation rates over those formerly used.

The British War Ministry cannot be charged with holding a brief for American manufacturers; therefore the rates of depreciation suggested in official memoranda of the War Ministry are of great interest as having direct bearing on conditions in the United States. When normal rates of depreciation on machinery were 7½ per cent per annum, it was suggested that there be allowed the following additions:

Addition for unskilled labor up to 50%	3¾%
Addition for overtime	11¼
Total additions	15%
Normal rate	7½
Total	22½%
Maximum allowance	25%

Engineers of the War Department of the United States reported that the British additional rates were too liberal and

recommended that the maximum to be used in the foregoing example be fixed at 15 per cent.

Taxpayers whose accounts are being examined should give careful attention to the actual conditions during 1917 and 1918 and when special depreciation was warranted by existing conditions, as compared with previous practice, they should insist on proper allowances.

Conditions Precedent to Allowance for Depreciation

The general provision in the regulations which sets forth the conditions which must be met before a deduction for depreciation is allowed reads as follows:

> Regulation. A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, and having due regard for expenditures made for current upkeep, at the end of such useful life to provide in place of the property its original cost (not replacement cost), or its value as of March 1, 1913, if acquired by the taxpayer before that date. . . . . (Art. 161.)

"Useful life," as used in the above regulation, has been interpreted by the Treasury to mean "the period of time over which an asset may be used for the purpose for which it was acquired." (C. B. 4, page 178; O. D. 845.)

It is proper that taxpayers should adopt a consistent plan and they should adhere to it until actual conditions call for a change. If it is calculated that machinery depreciates a given percentage under certain conditions, it is not inconsistent to change the percentage when conditions change.

Property depreciated must not be for personal use.—

Regulation. . . . . The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. . . . . (Art. 162.)

To quote the language of the Treasury:

Ruling. If used chiefly for pleasure, no depreciation deduction is allowable. (Bulletin "F," page 6.)

In the case of the farmer the regulations expressly permit depreciation on all farm buildings "other than a dwelling occupied by the owner."[6]

Depreciation of residence.—When a residence is used part of the year by the owner and is rented for part of the year, depreciation will be an allowable deduction for the period of the year when used for income-producing purposes. The depreciation is not necessarily based on the proportion of time during which the property is rented, because the actual depreciation during such time may be greater than during the time of occupancy by the owner. If the taxpayer owns a summer cottage and rents it for three months during the summer and occupies it personally during one month, it may be that the entire annual depreciation should be deducted since the facts would indicate that the property as a whole is held for income-producing purposes and that the occupancy by the owner for a short period is merely incidental. The test, however, would be the actual circumstances in each case.

Regulation. . . . . No such allowance may be made in respect of . . . . building used by the taxpayer solely as his residence, nor in respect of furniture or furnishings therein, personal effects, or clothing; . . . . (Art. 162.)

Residence used partly for business—or sublet.—

Ruling. If a portion of the residence is used for business purposes, as in the case of a physician or any other professional man who has his office in his home, a proportionate part of the deprecia-

[6] Art. 171; see Chapter XXXIX.

tion sustained may be deducted, the amount to be based generally on the ratio of the number of rooms used for business purposes to the total number of rooms in the building. The same principle is applicable if a taxpayer rents a portion of his personal residence to other individuals. Under such conditions, however, the taxpayer must include in his gross income any amounts received as rentals. A taxpayer who is not allowed a deduction for depreciation of his personal residence may, in case he sells the property, disregard depreciation in computing any taxable profit derived from the transaction.

If a taxpayer owns residential property and rents it to other individuals, he is entitled to a deduction for depreciation of the rented property even though the property is not used in his principal trade or business but must include in gross income the entire amount received as rentals. (Bulletin "F," pages 7 and 8.)

"COST" OF RESIDENCE IS NOT REDUCED BY DEPRECIATION.—

RULING. Inasmuch as no deduction for depreciation of the personal residence of a taxpayer is allowable in his income tax returns, a taxpayer in determining the gain or loss arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its fair market value as at March 1, 1913, by the depreciation sustained. (B. 30-20-1085; O. D. 600.)

Property which may be depreciated.[7]—

REGULATION. The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the property becoming inadequate to the growing needs of the business. It does not apply to inventories or to stock in trade, nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the statute. . . . . (Art. 162.)

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[7] For depreciation of land, see page 1098.
For depreciation of farm buildings, equipment and livestock, see Chapter XXXIX, "Farmers."

Potential earning power not subject to depreciation.—

Ruling. The potential earning capacity of an individual, his inventive genius or his literary ability may not be made the basis of an allowance for depreciation. (Bulletin "F," page 6.)

Replacements and renewals must not be twice deducted.— Expenditures for the upkeep of property range by imperceptible gradations from the most insignificant repairs to the replacement of the largest and most costly units. The law, of course, intends that all such expenditures shall be deducted, but the necessity arises of distinguishing between those which shall be deducted annually as expenses and those for which provision shall be made through cumulative depreciation allowances. In making this distinction, care must be taken to avoid the double deduction of expenses. The problem is complicated by the fact that minor repairs are made upon the most expensive machines. While theoretically it may be conceivable that depreciation rates might under some conditions be so delicately adjusted as to provide completely and perfectly for the entire upkeep of a machine or other piece of property, as a practical matter it is so difficult as to be impossible. The accountant's solution is to draw a somewhat arbitrary line between the small incidental items of repair, replacement and maintenance and the heavy items of renewal and replacement, charging the first group to expense and the second to depreciation reserves. The depreciation rates are calculated with this assumption in mind and consequently depreciation reserves should be kept free from charges except those for unquestioned renewals or replacements of major parts. The regulations satisfactorily cover this point in the following statement.

Regulations. . . . . Property kept in repair may, nevertheless, be the subject of a depreciation allowance. . . . . (Art. 162.)

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted

as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. . . . . (Art. 103.)

The Treasury in its latest rulings recognizes the necessity for proper repair and depreciation charges.

Ruling. Accordingly, amounts paid for repairs are not allowable deductions if they are duplications of allowances for depreciation. It does not follow, however, that there may not be in the same case allowable deductions both for depreciation and payment for repairs. As a rule, property that has been subject to use even though maintained in serviceable condition by repair has a shortened expectancy of usefulness. In such case there may be a deduction for payments for repairs and also a deduction for loss due to depreciation of the property which occurred despite the maintenance of such property in repair. (Bulletin "F," page 29.)

Closely related to this question is the treatment of expenditures for making improvements. This is discussed in the following decision of a United States Circuit Court which holds that improvements which are not permanent in character are deductible as expense:

Decision. (Syl.) Amounts expended by a business corporation in enlarging or making improvements in its office or premises, not in the nature of permanent improvements to the property, but to facilitate the transaction of a growing business, should properly be deducted as necessary expenses of the business. (*Connecticut Mutual Life Insurance Co. v. Eaton,* 218 Fed. 206.)

The principle outlined in the law and regulations appears to be clear, but considerable difficulty has arisen in its application because of the refusal of revenue inspectors to allow in some cases for both repairs and depreciation, on the ground that the former includes the latter. The practice is not uniform, the inspectors frequently differing in their interpretation of charges which may be either repairs or renewals. Naturally, they incline to the conclusion that where there is a doubt, the expenditure is a charge against the reserve, but good business practice requires that in case of doubt the

repairs be charged to operating expenses. The true issue is merely the avoidance of a double charge against income.

Inspectors have been known to hold that where a part of a machine which must be replaced frequently, such as a shuttle or a bobbin, which forms part of a loom, wears out or breaks, the replacement of such part should be charged against depreciation reserve, since this is intended to cover "deterioration of property on account of its use, wear and tear." In some concerns parts of this sort are termed "supplies," and as such are charged directly to cost of manufacturing. Upon the original acquisition of a loom, its entire cost, including installation of every part and action, ready to run, is charged to capital. The same rule applies to a sewing machine. First cost would include a machine equipped with needles, but it is not customary to set up a depreciation reserve for the renewal of needles. As purchased they are charged to supplies, or some similar account, and, subject to stock on hand at the beginning and end of the period, all purchases are charged to cost of manufacture, not to repairs. There is a slight error here which is too trivial to consider in practice, but one that evidently worries some inspectors. It is, that the renewal of a needle, costing perhaps one-tenth of one cent, should be charged to depreciation reserve, instead of supplies, because the first cost of the sewing machine was charged to plant. But this would be an impossible procedure, because renewals of this character are frequent. Therefore, the only error lies in the fact that a small part of the machine, assumed to have a life of, say, ten years, may have been renewed from time to time up to the end of the useful life of the machine. Accountants must disregard such fine distinctions.

Some manufacturing plants and mills produce in their own shops various parts of looms and other machines used to manufacture the principal products of the mills. These parts range from the largest to the smallest unit of each machine, so that over a period of years the looms are continually being renewed, particularly where the policy of the mill management

is to maintain the plant at the peak of operating efficiency.

In such cases complete analyses of the cost records should be kept in order to distinguish replacement items from those which are "incidental repairs."

Depreciation of leased machinery.—

Ruling. The M Company owns certain apparatus which it leases under contracts for a period of years at an agreed rental. The contracts provide that the lessor shall maintain the apparatus for the period of the contract without charge to the lessee and that the apparatus shall remain the property of the lessor. Although the apparatus is of some value at the expiration of the lease, such value is less than the cost of its removal and it is therefore abandoned by the lessor at the expiration of the lease.

The expenditure for labor incident to the installation of the apparatus, being possible of allocation thereto, and the cost of the material entering into the installation are held to be capital expenditures, recoverable through depreciation spread over the term of the original lease. If the apparatus had a salvage value at the expiration of the lease it would be necessary to take this value into consideration in computing deductions for depreciation as provided in article 161 of Regulations 45. (B. 44-21-1894; O. D. 1082.)

The costs of maintaining the apparatus under the terms of the contract are, of course, chargeable against current income.

Depreciation of railway roadway offset by maintenance and appreciation.—In a recent case,[8] the court held that:

Decision. (Syl.) 1. Deductions—Depreciation—Loss in Value of Roadbed of Railroad.

No deduction for depreciation in value of the roadway of a railroad may be taken where, because of repairs, renewals and replacements, the roadway as a whole is as valuable at the end of the taxable year as at the beginning.

2. Deductions—Depreciation.

The depreciation which may be deducted in determining net income is the decrease in intrinsic value due to wear and tear, decay, obsolescence, etc., of the physical property suffered during the taxable year as distinguished from the market value.

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[8] *Nashville, Chattanooga and St. Louis Ry. Co. v. U. S.*, 269 Fed. 351; certiorari denied, 65 L. Ed. —.

3. Deduction—Depreciation—Loss in Value of Separate Units —Appreciation of Other Units.

The roadway must be considered as a whole in determining whether depreciation has been sustained, and the loss in value of separate units of the roadway may be offset by appreciation in other units.

4. Evidence—Sufficiency of Repairs, Renewals, and Replacements to Offset Depreciation.

There was sufficient evidence that the repairs, renewals, and replacements made offset any loss in value, and that the roadway had not decreased in value, to justify the trial court in refusing to direct a verdict.

The decision of the court reads in part as follows:

Decision. . . . . It was was admitted by defendant's chief engineer that the expenditures for 1909 "kept the road in a normal condition to carry on its business," that "its normal condition was a good condition," and that the expenditures "had made good the normal amount of depreciation." There was testimony by competent witnesses of railway experience that "there may be depreciation in the units comprising the roadway, track, and structures of the railroad, while there is no depreciation in the machine as a whole;" also that it is possible "to maintain the roadway, track, and structures so that there will be no depreciation if we consider the roadway, track, and structures as a composite whole;" also that "the service life of any normally operated and normally and well maintained railroad is perpetual, and it is maintained in the condition of property serving its purpose by annual renewals and replacements." The testimony, considered as a whole, tended to support the conclusion that the amounts expended by defendant during the years in question for repairs, renewals, and replacements should and would have fully offset the depreciation in the various units, and that the defendant's railway and structures were, as a whole, maintained throughout the years in question in fully as good condition, and were of fully as great intrinsic value as at the beginning of the respective years. The jury would have been clearly justified in inferring from the testimony of defendant's chief engineer, taken as a whole, that the value of the roadway had not depreciated during the two years in question; in other words, that the repairs and renewals that had been made were of such a character as to leave the road at the end of each year of value equal to that at the beginning of the year. That officer's testimony so impressed the trial judge, who stated his opinion from the evidence that "there is no reasonable deduction for depreciation established." Defendant did not directly controvert the situation so shown. Its chief, if not its only reliance, seems to have been on the proposi-

tion that in spite of it all there was inevitable annual depreciation in some of the perishable elements not entirely renewed or replaced, so justifying the contention that for this reason there was depreciation within the meaning of the Act, even though the roadway as a whole had not decreased in value. To this argument, as already said, we can not assent. It follows that the trial judge rightfully refused to instruct verdict for defendant.

With reference to appreciation offsetting depreciation, the court in the same case said:

The contention on which defendant seems to rest its chief criticism seems to be that, notwithstanding the roadway as a whole was intrinsically just as valuable at the end of the year as at the beginning of the year, that is to say, although depreciation in given units had been fully overcome by appreciation in others, the railway company would still be entitled to credit for depreciation in such individual units as had depreciated. We think this contention of defendant not sustained by reason or authority, and that the court correctly charged the true criterion. If, as is not entirely clear, it is meant to further suggest that the consideration of functional (as distinguished from physical) depreciation was not allowed by the charge to be taken into account, the suggestion is plainly without merit. Not only did the court define the roadway as including "structures connected with the roadway, such as stations, tool houses and matters of that sort," but it included in depreciation a lessening of original values, "due to wear and tear, decay, gradual decline from obsolescence, that is, getting out of date and inadequacy." In our opinion the jury was given the correct rule for determining the existence or nonexistence of depreciation, which accords with the "ordinary and usual sense" of that term "as understood by business men." *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 524. To say that property can depreciate without impairment of either intrinsic value or efficiency is to our minds a solecism.

The foregoing opinion accords neither with good accounting principles, nor with the position of the Treasury. The case was brought under the 1909 law and may not be considered as a precedent for procedure under subsequent laws. It is inserted at this point as an illustration of the uncertainty of court decisions. It is a Circuit Court, not a Supreme Court, decision.

CERTAIN REPAIRS ARE PROPERLY CAPITAL EXPENDITURES.—Although it is an accepted rule that repairs and all other expenses of maintenance should be charged against profit and

loss, an exception to this rule is found in cases where partly worn-out or run-down plants are purchased with the intention on the part of the new owners to rehabilitate them so that they can be operated efficiently. It may be assumed that the purchase price takes the poor condition of the plant into consideration, in which case the entire cost of repairs and renewals may properly be capitalized.

REGULATION. Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. . . . . (Art. 293.)

If the replacements are of a *permanent* nature they are chargeable to capital.

RULING. The amount expended by a taxpayer during any taxable year or period for improvements, replacements, or renewals of a permanent nature is a capital investment and is not deductible from his gross income for such taxable year or period. The amount so expended should be charged directly to the property account or to the depreciation reserve account, dependent upon how depreciation charges are treated in the books of account, and a pro rata portion thereof deducted as depreciation each year of the life of such improvements, replacements, or renewals. (Bulletin "F," page 29.)

Depreciation must be entered upon the books of a corporation.—Neither the 1921, nor the 1918, law specifies that depreciation must be charged off on the books of an individual or a corporation,[9] but in other sections of the law the Commissioner is given ample power to enforce proper accounting methods. It may be assumed, therefore, that all corporations and all individuals who keep books must enter depreciation on their books or it will not be allowed as a deduction. The restriction is a proper one.[10] The author has no sympathy for

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[9] See page 1050.

[10] **[Former Procedure]** Such a restriction upon corporations was contained in section 12 (a), second, of the 1916 law.

The 1913 law contained no such provision, but the Treasury nevertheless ruled that "in order to be allowable . . . . the loss . . . must be so entered upon the books of the company as to constitute a liability against its assets." (Letter to collectors, August 27, 1914.) This ruling, while it did not follow the law, conformed to correct account-

any corporation which is not willing to have its income tax returns agree with its books. The regulations of significance follow:

Regulation. A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance sheet. The allowances should be computed and charged off with express reference to specific items, units, or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. The taxpayer should keep such records as to each item or unit of depreciable property as will permit the ready verification of the factors used in computing the allowance for each year for each item, unit, or group. (Art. 169.)

Banks may keep additional records for depreciation purposes.—

Ruling. Held, that where banks under Federal or State statute are required to submit periodically to the Comptroller of the Currency or to the State Banking Commissioner a statement of financial condition, additional records and books may be kept which reflect the correct investment account and net income for income and excess profits tax purposes and that any adjustments made thereon with respect to the banking house furniture and fixtures, depreciation, etc., should be accepted as meeting the requirements of the law and regulations for income and excess profits tax purposes. (C. B. 4, page 64; A. R. R. 377.)

The reason for this ruling is that the statements rendered to the federal or state authorities frequently include adjustments, for instance, the writing down of investments to market

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ing. Accurate accounting requires that depreciation be shown on the books, but the mere existence of the book record does not make actual depreciation more or less. The courts rightly took the position that if a definite, easily proven diminution of value had occurred, the mere non-entry of it on books of account could not possibly serve to negative the fact. As in so many other matters, the Treasury was inconsistent in its ruling on the book record of depreciation, because, in general, it took the proper position that book records are subordinated to facts, while in this respect its position was that the fact is subordinated to the book record.

values or the inclusion in expenses of additions to the banking house or its equipment, which are not permissible for income tax returns.

Only charges applicable to current year deductible.—Recent rulings have now settled beyond question the principle that only those depreciation charges which are properly applicable to the current year may be deducted in that year, and any readjustment must be made by filing amended returns (see page 1067). The Treasury has ruled:

RULINGS. The deduction for depreciation and obsolescence allowable in the return for any taxable year or period is an amount sufficient to cover the reduction in value of property through exhaustion, wear and tear through use in the trade or business during such taxable year or period. The fact that depreciation and obsolescence have been sustained in prior years but were not claimed as a deduction in returns of net income will not warrant the deduction of an increased amount during the current year. The taxpayer's remedy lies in filing amended returns for prior years in which such deductions may be claimed and claims for refund of excess taxes paid. (Bulletin "F," page 35.)

. . . . It is further held that since the general plan of both the income and profits taxes is to levy a tax upon an annual basis, and as there is no authority in the statute for offsetting against income received in one year, losses sustained in a prior year by reason of depreciation, except as provided in sections 204, 214 (a) 12, and 234 (a) 14 of the statute, only such depreciation as was sustained during the taxable periods covered by the returns may be claimed. (C. B. 4, page 180; O. D. 948.)

A regulation[11] makes specific provision for an alteration in the rate of depreciation in cases where the life of the property has been underestimated, but does it, not by reconstructing the entire depreciation history of the property with readjustments in the returns for previous years, but rather by distributing the remaining portion of the value not covered by depreciation over the estimated remaining life of the property. It would seem that the converse of this would also apply, viz., that if the life of the property was overestimated, the

[11] Art. 166; see page 1081.

rate of depreciation should be increased during the remaining years of its life sufficiently to cover the loss.

Good accounting practice requires that lump sum purchases be segregated on the books of account. It is better to open too many accounts than too few, because experience demonstrates the fact that depreciation is more easily ascertained by the use of a number of ledger accounts than when undivided property or plant accounts are kept.

When it is impossible definitely to allocate the cost, it should be prorated on some equitable basis or by a new appraisal made as of date of acquisition.

Amended returns may be necessary.—It may be necessary to prepare amended returns from 1913 to the time when the adjustments are made. If the amount involved is substantial there is no other way of correcting the former erroneous practice.

The regulations are fair and reasonable in that taxpayers are required to make each year's returns include accrued depreciation for only one year. The adjustment of accounts will work out to the advantage of the government and to the disadvantage of the taxpayer if the depreciation allowance is decreased during a period of high taxes and *vice versa*. But taxpayers should keep in mind that actual depreciation, in almost all cases, was far greater during the years 1917 and 1918 than during the pre-war period.[12]

Amended returns acceptable to Treasury.—If original returns were made in good faith, they may be corrected if found to be erroneous. The following ruling also requires that any depreciation allowance claimed must be entered on the taxpayer's books.

Ruling. The statement . . . . to the effect that the depreciation allowance must be charged off before it can be deducted does not mean that depreciation sustained during one year may be charged out of the income of another year for income tax purposes; neither

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[12] See page 1053 *et seq.*

does it mean that failure to deduct depreciation before closing accounts for the year will prevent its ultimate deduction by the taxpayer. It means that if the taxpayer inadvertently neglected to make the proper entries on his books before closing them for the year during which the depreciation was sustained and failed to make the proper deduction from gross income in his return for that year, he may reopen his books, make the proper adjustment entries on them, and file an amended return showing the proper deduction for depreciation, provided bad faith or gross negligence was not shown in the preparation of his original return and in the manner in which he kept his accounts. (Bulletin "F," pages 33-34.)

Depreciation should be based on cost or value March 1, 1913.—The 1921 law specifically provides that in the case of property acquired before March 1, 1913, the value as of that date is the proper basis for estimating depreciation. If the property was purchased after March 1, 1913, the cost of the property is the basis for computing depreciation. In the case, however, of property received as a gift after March 1, 1913, and before December 31, 1920, depreciation is based on the fair market value of the property at the time of the gift.[13]

Regulation. The capital sum to be replaced by depreciation allowances is the original cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should be added from time to time the cost of improvements, additions and betterments, the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. . . . . (Art. 164.)

This rule, of course, departs somewhat from the usual accounting procedure because of the insertion of March 1, 1913, as the date for establishing a value for purposes of depreciation. The ordinary practice is to take original cost,

[13] See page 620.

determine a liberal depreciation rate and, when the reserve equals the original cost, discontinue depreciation.

RULING. Prior to the approval of Treasury Decision 2754 (August 23, 1918) depreciation allowances were required to be based on the cost of the property. This Treasury decision authorized depreciation deductions based on the value of property as of March 1, 1913, if acquired prior thereto. The basis in the case of property acquired on or after that date remained unchanged.

In an opinion rendered by the Solicitor of Internal Revenue it was held that Treasury Decision 2754 is applicable to returns for 1913 and all subsequent years. This Treasury decision was based on a prior opinion of the Solicitor of Internal Revenue in which it was held that the depreciation charges allowable for any year represent the portion of the gross income of the year necessary to make good a capital shrinkage, that the charges should therefore be such as to amount in the aggregate during the life of the depreciating property to the value of that property as a capital asset; and that under the United States Supreme Court decisions in *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179, and *Lynch v. Turrish*, 247 U. S. 221, this capital value should be determined as of March 1, 1913. (Bulletin "F," page 19.)

If March 1, 1913, value was substantially in excess of the cost less depreciation to that date, amended returns for subsequent years embodying revised depreciation allowances would be in order.

FUTURE REPLACEMENT COST NOT A FACTOR.—

RULING. Replacement value of property can not be substituted for the cost of the property as the cost of replacement at a time some years in the future is a speculative figure which can not be used as a basis for determining an annual depreciation charge. The depreciation charge will replace the amount of the original capital outlay, which may be more or less than adequate to replace the item to which it applies. If less than adequate, new capital must be provided from surplus or otherwise to effect the replacement. (B. 21-19-524; O. D. 283.)

DEPRECIATION COMPUTATION IN CASE OF REORGANIZATIONS.—

RULING. A corporation engaged in refining gasoline was liquidated and its assets including automobiles, office furniture and equipment, and absorption gasoline plants, were transferred to a partnership organized by its stockholders. The question is raised as to

whether the partnership shall base its claim for depreciation upon the original cost of the assets or upon their original cost less depreciation charged off by the corporation. . . . . If, in the liquidation of the corporation, the fair market value as of the date of the distribution of the assets received by any stockholder, was in excess of the cost of his stock or its fair market value as of March 1, 1913, if it was acquired prior to that date, the amount of the excess represented taxable income subject to both the normal and the additional tax for the year of its receipt. The fair market value of the assets as of the date of liquidation of the corporation will be held to be the cost of the assets to the stockholders who, as partners, turned the assets over to the partnership, and will be the basis for determining the depreciation allowance to be claimed each year with respect to such assets. . . . . (B. 34-20-1148; O. D. 639.)

The foregoing ruling is based upon the principle of a "closed transaction." If a transfer of title constituted a "continuing" transaction, this change in the depreciation base would not be permitted.[14]

When assets are transferred, care should be taken to transfer them at gross book value and not after deducting any reserve that may have been set up on the books of the old firm. In some cases revenue agents have computed depreciation on such net figures at the old rates. This of course results in much smaller depreciation deduction for the taxable year of the new concern. If the net value of the assets is used, the rate of depreciation should be increased to reduce the assets to salvage value at the end of their useful life.

Revaluation as of January 1, 1909, applicable to corporation excise tax only.—In all cases relating to depreciation during the period January 1, 1909, to February 28, 1913, the fair value of property at January 1, 1909, is still a factor.

As to 1913 and subsequent years, both for the purpose of determining taxable profits on sales and allowances for depreciation, corporations may revalue their assets as of March 1, 1913, whether or not a similar revaluation was made at January 1, 1909. If the value at March 1, 1913, was in ex-

[14] For discussion of what constitutes a "closed transaction," see page 536.

cess of the January 1, 1909, valuation, no tax is imposed thereon even though realization takes place after March 1, 1913.

Assets revalued on a corporation's books as of January 1, 1909, in an amount in excess of the book value at that date, revalued again as of March 1, 1913, in an amount in excess of the January 1, 1909, valuation and sold since March 1, 1913, at a still greater value, will be taxable only on the difference between the March 1, 1913, value and the price realized.

No tax on appreciation can now be collected under the 1909 law, and no tax can be collected under the 1913 and later laws on any appreciation which accrued prior to March 1, 1913.[15]

Depreciation of depreciable and non-depreciable property acquired after March 1, 1913.—

REGULATION. . . . . In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition. (Art. 164.)

When depreciation deduction results in deficit.—

RULING. Corporate taxpayers in some cases compute their net income for the taxable period without having made allowance for depreciation and then distribute the entire net income so computed to their stockholders so that the books show no surplus or undivided profits. In such cases if a corporation subsequently desires to avail itself of the privilege of deducting an allowance for depreciation in its return for such taxable period it must first reopen its books and make the appropriate charges. . . . It will then be placed in the position of having paid a dividend from a depreciation reserve or from capital to the extent that the amount of dividend paid exceeds the true net income, meaning the net income *after* making proper charges for depreciation. The amount of the excess will be deemed a distribution in partial liquidation and taxed accordingly to the stockholders, and the invested capital of the corporation for excess profits purposes will be deemed to have been reduced to the same

[15] For discussion of taxability of dividends paid from realized appreciation, see page 715.

extent in accordance with article 860[16] of Regulations 45. (Bulletin "F," page 35.)

Ruling. In computing the taxable net income of a corporation, it can not be denied a deduction on account of depreciation actually sustained and charged off, even though after paying dividends there remains an amount of surplus and earnings insufficient to cover depreciation. In such case the book value of the assets must be reduced by an amount equal to the difference between the amount of the depreciation actually sustained and charged off and the amount of the earnings and surplus available for depreciation at the end of the taxable period. (C. B. 4, page 180; A. R. M. 112.)

When the depreciation deduction is in excess of the net earnings, a net loss results which under the 1921 law may be carried forward to a subsequent year.[17]

Depreciation in cases of permanent discontinuance.—

Regulation. If the use of any property in the business is permanently discontinued, although no sale or other disposition of the property has taken place, a determination of any gain or loss may be made; but any deduction in respect of any loss thereon must be disclosed in the taxpayer's return for the year in which the determination is made and a full statement of the facts and the basis upon which the computation is calculated must be attached to the return. Upon a sale or other disposition of the property, the consideration received shall be compared with the amount of the estimated salvage value used in computing the gain or loss as above provided, and the amount of the difference shall be treated as a gain or loss, as the case may be, of the year in which the sale or other disposition was made. . . . . (Art. 170.)

A loss arising from discontinuing the use in business of depreciable property may be due to obsolescence. That subject is discussed in Chapter XXXII.

Depreciation claimed by fiduciaries and beneficiaries.— The procedure is prescribed by the Treasury as follows:

Ruling. An individual who receives income from a trust estate may not deduct from gross income in his individual income tax return any amount representing depreciation of property belonging to the estate. However, under the Revenue Act of 1918 it is permissible for

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[16] See page *Excess Profits Tax Procedure*, 1921, page 251.

[17] Net losses are discussed on pages 1021-1029.

the fiduciary in ascertaining the net income of the estate or trust for which he acts to deduct a reasonable allowance to cover the depreciation sustained during the taxable year, whether or not the terms of the will or agreement creating the estate or trust or a decree of court provide for taking care of the depreciation which may be sustained on the property held in trust.

Estates and trusts are under certain circumstances treated as a unit, and in other cases may represent an aggregate of distinct interests to all of which the fiduciary is responsible. Irrespective of whether the estate or trust is or is not treated as a unit, the fiduciary in computing the net income upon which he is required to pay the tax may claim a deduction for depreciation. . . . [18] (Bulletin "F," pages 32-33.)

Depreciation of property acquired by gift.—

RULING. If a taxpayer acquires depreciable property by gift, bequest, or devise, and uses it for purposes of trade or business, he is entitled to a deduction from gross income for depreciation of such property. . . . the deduction is based on the fair market price or value of the property at the date when acquired, or if acquired prior to March 1, 1913, its fair market price or value as of that date, and its remaining useful life in the trade or business, proper adjustment being made from time to time by reason of improvements, additions, betterments, or losses since acquirement or since March 1, 1913. (Bulletin "F," pages 9 and 19.)

The foregoing applies to property acquired by gift before December 31, 1920.

Section 202 (a-2) of the 1921 law provides that, for the purpose of computing gain or loss on subsequent sale, property acquired by gift after December 31, 1920, is to be deemed to have the same cost or March 1, 1913, value (if acquired prior thereto) as if still in the hands of the donor.[19] The question arises as to what value the donee should use for depreciation purposes in case the gift consists of depreciable property. The donee might conceivably use one of two values:

(a) Value at date of gift.

(b) Cost to donor or March 1, 1913, value if acquired by the donor prior thereto.

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[18] See discussion of depreciation allowances to beneficiaries, Chapter XXXVII.

[19] See page 619.

In case (a) the donee would be basing depreciation on an appreciated or depreciated value as compared with the cost to the donor which, under section 202 (a-2) is now assumed to be the cost to the donee. It would seem that if (b) is to be the basis on which the donee must compute gain or loss in case of sale, the Treasury will use the same basis for depreciation purposes.

Depreciation divisible between joint owners.—

RULING. A joint owner of inherited property, collecting rents and profits from such property and managing the property on behalf of all the owners, pursuant to an oral agreement, is an agent and not a fiduciary. It is, therefore, necessary for each of the joint owners to file an income tax return and account for his share of the income from the property in addition to income received by him from other sources. In preparing such returns each joint owner may claim as a deduction for each year his proportionate share of the depreciation allowance for such year with respect to the property held in joint ownership.[20]

Reserves for Depreciation

According to the regulations the particular manner in which the depreciation allowed as a deduction pursuant to the law is entered on the taxpayer's books, is not material except that the amount "must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account,[21] which must be reflected in the annual balance sheet." (Art. 169.)

Use of depreciation reserves.—The Treasury no longer holds the very narrow view it once held as to the investment of depreciation reserves in the concern's own plant.

The amounts reserved for depreciation need not be specifically invested.

RULING. While the presumption is that amounts credited to these accounts will be used to make good the loss sustained, either through

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[20] Bulletin "F," page 33.

[21] **[Former Procedure]** For discussion of former regulations see *Income Tax Procedure,* 1918, pages 364-366.

a renewal or replacement of the property or a return of capital, there is no requirement of law that the funds represented by these reserve liabilities shall be held intact or remain idle against the day when they may be used in making good the depreciation of the property with respect to which the deduction is claimed or in restoring the capital invested in the depreciated assets. (Bulletin "F," page 34.)

Rates of Depreciation—General

The law in regard to rates specifies merely that the depreciation allowances shall be "reasonable," and the Treasury very sensibly makes no attempts to fix specific rates which shall be considered satisfactory.

REGULATION. The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made.[22] (Art. 165.)

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[22] Methods of determining depreciation allowances:

1. The fixed percentage basis. This method is the most popular and is the one in general use. It is applied as follows:

(a) On a flat basis, e.g., if the life of a machine is ten years, one-tenth, or 10 per cent, is charged off annually.

(b) On a reducing scale basis, i.e., a rate is ascertained which, when applied to the original cost and the diminished value thereof as periodically determined, will reduce the book value to scrap value at the end of the machine's estimated life.

2. Sinking fund method. If it is proposed to set aside such a sum periodically as will equal the original cost of a machine (less scrap value) at the end of its estimated life, it is customary, after taking into consideration the average rate of interest which can be secured, to pay into a fund a fixed amount periodically. The aggregate thereof, together with the accumulated interest, will equal the amount required to renew the machine in question. This method is in practice seldom followed.

There is good authority, however, for its use where a single large piece of property, such as an office building, apartment house or ship is being operated which is eventually to be replaced.

3. Production method. A method of making depreciation allowances which has its advantages under certain conditions is that of

RULING. It is the opinion of this office that neither the opening nor the closing balance of the asset accounts is the proper value upon which to base depreciation allowances for any taxable year in which improvements, additions, or betterments have been made to depreciable property or in which depreciable assets have been abandoned or scrapped. If the opening balance is used in such cases the taxpayer will not be given the benefit of a deduction for the amount of depreciation sustained in the taxable year on the additions made during the year, while a deduction would be allowed for a full year's depreciation on the assets discarded during the year. On the other hand, if depreciation is computed upon the closing balance, the taxpayer would not be allowed a deduction for any depreciation sustained during the year upon the assets abandoned, while a deduction would be allowed for a full year's depreciation upon the assets acquired during the year. This office is also of the opinion that in such cases the proper allowance for depreciation of the assets acquired or discarded during the year is that proportion of the depreciation of such assets for the entire taxable year which the portion of the year during which the assets were used in the trade or business bears to the full taxable year.

It is held, therefore, that depreciation should be computed for the entire taxable year only upon those assets which were properly included in the opening balances of the depreciable asset accounts and which were not abandoned or scrapped during the taxable year. Depreciation should be computed on each asset discarded during the year at the proper annual rate for the period from the beginning of the year to the date the asset was abandoned, and upon each improvement, addition, or betterment made during the year the cost

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charging an established rate per unit of output. This is especially applicable in the case of, say, a blast furnace where the frequency with which the linings will need to be renewed depends on the extent to which the furnace is being used. If it is being run at full capacity night and day, the wear on the linings is obviously much greater than if the furnace were not in continual use during the entire fiscal period.

Another species of depreciation which may be said to come under the above caption is that caused in a plant by the exhaustion of the mines or timber lands for the operation of which the plant was constructed. Most of the value of coke ovens, for instance, is gone when the mines for which they were constructed are worked out. Consequently, in determining the amount to be written off for depreciation of mining and lumbering plants, the factor of the probable future output of the mines or lands will be an important one and it will frequently be found advisable to base the plant depreciation charge on the output. Certainly this should be done where it is evident that the plant will outlive the exhaustion of the mines or lands. In such cases the depreciation charges should be sufficient to absorb the entire cost of the plant, less residual value, by the time the mines or lands are exhausted, even though at that time the plant may still be in good operating condition. Of course, any actual residual value must be considered.

of which is not deductible from gross income as a business expense, at the proper annual rate for that portion of the taxable year intervening between the date the improvement, addition, or betterment was made and the close of the taxable year. It is to be understood, of course, that if in any case the improvements, additions, or betterments made or the assets discarded were, during the taxable year, so numerous and in such small amounts that the time and labor involved in computing depreciation in this manner upon each separate improvement, addition, or betterment or asset abandoned would be so disproportionate to the resulting change in tax liability as not to warrant depreciation being so computed, such changes in the depreciable assets may be considered to have occurred ratably during the year and depreciation computed upon the average of the opening and closing balances of the asset account, such average being determined by adding together the balances at the beginning and end of the taxable year and dividing by 2. (I-2-18; I. T. 1158.)

The foregoing ruling merely states the rule that depreciation can only be taken on "property used in the trade or business,"[23] and that where changes take place during the year in the amount of depreciable property, effect must be given thereto.

Depreciation methods approved by Treasury.—The Treasury has approved only two methods, but is willing to adopt other methods if they are found to be more accurate.

Fixed percentage method.—

Ruling. . . . . . The "fixed percentage" method as applied by the Commissioner contemplates that the annual depreciation deductions with respect to any property should be equal; that the rate of depreciation should be assumed to be uniform during the useful life of the property, as compared with the so-called "fractional method—weighted years," "declining balance method—scientific or unscientific," "revaluation method," and "sinking fund method," the use of which is advocated by accountants, but none of which have been approved in their entirety by the Commissioner for income tax purposes. (Bulletin "F," page 31.)

Production method.—

Ruling. The only other method which has been approved by the Commissioner is an apportionment of the depreciation charges

[23] Section 214 (a-8).

over the total amount of work to be performed or over units of production. For example, a contractor may purchase machinery for use only in performing a certain contract, which machinery will be worthless or have little or no salvage value upon completion of the contract on which he will be engaged for the whole of one taxable year and half of the succeeding taxable year. But the number of units of work, or percentage of completion accomplished during the first period of 12 months and during the second period of six months, may be equal. The contract may call for the making of an excavation, and the same number of yards may be excavated during each of the above periods. Under such circumstances, if the contractor returns his gross income each year on the basis of percentage of completion of the contract, he will be permitted to spread the total amount of the depreciation allowance equally over the two periods, deducting half of the total amount in his return for the first 12 months, and the other half in his return for the succeeding taxable period.

If the contractor had returned his income on some basis other than that of percentage of completion of the contract, it would have been necessary for him to modify his basis for computing the depreciation allowances. Thus, if the gross income was returned on the basis of time required for completion of the above contract, two-thirds of the gross income being reported in the return for the first 12 months, and the other third reported in the return for the succeeding period; in that case two-thirds of the total depreciation allowance would be deducted in the return for the first period and the remainder in the next return. (Bulletin "F," page 31.)

The intention of the foregoing illustration is to permit an equitable deduction for depreciation. When the allocation mentioned does not work equitably, it is permissible to adopt a method which reflects the true net income for each period.

Dependence upon life of enterprise as a whole.—The "number of years constituting its life" and the permissible revaluation as of March 1, 1913, are vitally affected in the case of some types of property by the life of the enterprise in which it is used. In the case of a mine or an oil or a gas well, the deposit may be exhausted before the expiration of the normal life of some of the buildings and machinery. The regulations provide that in the case of oil and gas properties the depreciation shall be such "an amount, based upon its cost (or fair market value as of March 1, 1913, if acquired prior to that

date), equitably distributed over its useful life, as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired."[24] A somewhat similar provision is made in the case of mining properties[25] and timber properties.[26] In the case of a building constructed on leased land, if "the life of the improvement is less than the life of the lease, the depreciation may be taken by the lessee, instead of treating the cost as rent."[27] This, of course, is basing the depreciation rate on the life of the improvement, rather than on the duration of the lease.

RULING. Held, ... that the cost of the new boilers, less salvage value, may be recovered by annual deductions spread over the period of the estimated remaining timber supply, it being assumed that at the end of this period the cost of removing the boilers to a new timber region will be more than their worth in the new location. . . . . (C. B. 4, page 179; O. D. 871.)

ENTERPRISES AFFECTED BY THE CLOSE OF THE WAR.—The "useful life" of much war property did not extend beyond the end of the war. What is the proper term to use for the accruing expense or cost incident to idle plant? If depreciation were permitted only for wear and tear of a plant constructed to manufacture war materials, which has not been used since the war ended, the owner would be in a bad way.

Many contracts let by the government itself specifically provided for extraordinary depreciation rates to be included as part of the cost of production of war materials. The munitions tax law permitted the amortization of plants used for war purposes over the estimated war production.

The 1921 law re-enacts the provisions of the 1918 law which takes care of depreciation due to war conditions.[28] As the loss is one due to extraordinary obsolescence, the matter is fully discussed in Chapter XXXII.

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[24] See Art. 225, page 1107.
[25] Art. 224; see page 1105 *et seq.*
[26] Art. 227; see page 1234.
[27] Reg. 45, Art. 109; see page 903.
[28] Sections 214 (a-9), and 234 (a-8).

Depreciation of plant or equipment devoted to war purposes acquired before April 6, 1917, is also discussed in Chapter XXXII.

Depreciation a local issue.—The taxpayer must take local conditions into account in considering rates of depreciation. In one locality boilers may depreciate 7½ per cent annually; in another the rate may be 15 per cent; and the variation may be entirely legitimate. It is not merely a question of the quality of the boilers. No engineer or boiler manufacturer can give an intelligent estimate unless he knows the use to which the boiler is subjected, the climate, the water, the class of labor, the probabilities of shut-downs, etc. A similar situation exists in the case of almost all other classes of property which depreciate by wear and tear. Therefore, wherever rates of depreciation are mentioned in this chapter, they must be taken as suggestions only and be treated as rough approximations of what may be expected under normal conditions.

A table of depreciation rates applicable to specific depreciable assets, with the names of the authorities for the rates given, may be found at the end of this chapter (page 1123).

Depreciation rate affected by "overtime" or "overload."—When machinery is run "overtime" there is little opportunity properly to repair and maintain the machines. Moreover, a two-shift system means divided responsibility, and with divided responsibility the machinery is sure to suffer. New workmen and those on night duty are often less efficient than the regular staff and there is a consequent ill effect upon the machines.[29] In spite of all this some inspectors have been reluctant to allow special depreciation when a plant was being run "overtime." Consequently the following is of great interest:

Ruling. It is recognized also that property, for example, manufacturing machinery, may be subject to extraordinary depreciation due to being operated overtime, at an overload, or being used for

[29] For British practice, see page 1054.

some purpose for which it is not adapted. Under such conditions, a taxpayer may deduct in addition to the amount measuring the depreciation under normal conditions, a further sum to provide for the extraordinary depreciation. It does not necessarily follow that if a machine operated normally for 8 hours a day, is operated for 16 hours a day, it will depreciate twice as rapidly as when operated under normal conditions. The estimate of the extraordinary depreciation should be made by the taxpayer according to his judgment and experience and will be subject to the approval of the Commissioner. (Bulletin "F," page 27.)

Adjustment of rates used in former years.—The author believes that deductions for depreciation claimed and allowed in returns during the years preceding the taxable year should be reopened only under special conditions. Corporations and individuals subject to the taxes in force during those years were on notice from the government as to the basis of the allowable deductions and were also on notice from accountants and bankers that proper provision for depreciation should be made. What was done at the time, while the facts were fresh in mind, should stand unless an explainable mistake was made. Depreciation rates should be neither played with nor juggled. The rates of an income tax should not (because they *do not*) determine depreciation rates. Unless the Commissioner is convinced that a meritorious case exists, he should not permit amended returns to be made.

When, however, it is discovered that depreciation was incorrectly calculated to a substantial amount in prior years, it is not good accounting practice to make the adjustment in the taxable and subsequent years. It is not fair either to the government or to the taxpayer.

REGULATION. If it develops that an error was made in estimating the useful life of the property, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. Inasmuch as under the provisions of the income tax Acts in effect prior to the Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was

sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future (not past) obsolescence as may be expected from experience to result from the normal progress of the art. . . . . (Art. 166.)

Under the foregoing regulation, obsolescence which has not been absorbed in depreciation charges, and which is acknowledged to have "accrued" prior to 1918, can never be deducted. For discussion see page 1130.

Excessive rates—negligence not imputed.—

Ruling. . . . . If understatements of taxable net income in returns are due to charging off depreciation in excess of an amount deemed reasonable by the Commissioner, negligence or intent to defraud will not be imputed to the taxpayer unless the position taken is so unreasonable as to indicate gross carelessness or bad faith. (Bulletin "F," page 27.)

Special depreciation of excessive costs.—Ample provision has been made for special depreciation of plants and equipment constructed or purchased "for the production of articles contributing to the prosecution of the present war."[30] The question arises as to what provision, if any, has been made for plants which cannot qualify in the war work class.

Commencing in 1915, almost all classes of materials advanced in price until the cost of erecting and equipping a plant was perhaps double what it had been before the war.

For example, take a plant which cost a million dollars to build and equip in 1913. The plant is duplicated in 1918 at a cost of two millions. What rates of depreciation shall be charged during 1919 on the two plants? If the proper average rate on the old plant is 8 per cent, is that the proper rate on the new plant? Is $160,000 per annum for the new plant the equivalent of $80,000 for the old plant? Strictly speaking, it is equivalent because depreciation rates, when accurate, are based on the effective life of the plant, and if reserves at the rate of 8 per cent per annum will provide a fund

[30] See Chapter XXXII.

sufficient to recoup the cost of the plant as it wears out, no higher rate is permitted under a strict interpretation of the existing law.

There is, however, a sound foundation for a claim to extra depreciation on the part of those who have erected plants during this period of high prices, even when the plant will not become obsolete after the war.[31] It can be assumed that anyone who built a plant under the conditions which have existed during the recent past did so because he counted upon being able, through the profits of this abnormal period, to write off that part of the cost of the plant which was clearly supernormal so that he might be on the same cost basis after the return of peace as the proprietors of other plants built before or after the period of very high prices.

The foregoing argument must not be construed to support increases in current depreciation rates where the cost of the property involved was normal although recently purchased, nor in any case where the property was acquired prior to 1915.

Depreciation of plant or equipment acquired before April 6, 1917.—The foregoing comments refer in general to all classes of plant and equipment no matter when purchased. The 1921 law re-enacts the provisions of the 1918 law which provide full relief for losses on plant and equipment acquired after April 6, 1917; but no special relief for losses arising out of the subsequent fall in value of property acquired at the high prices which prevailed after 1915 and before April 6, 1917, is found in the law. The Commissioner, however, may hold that a reasonable allowance for depreciation as applied to special conditions means a higher allowance than under ordinary conditions.

It is almost safe to assume that all plants erected during 1916 and early in 1917 were operated under adverse condi-

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[31] See Chapter XXXII. For a discussion of the use of replacement funds in the case of losses through war hazards, see Chapter XV.

tions and that the actual depreciation which took place was probably double normal depreciation.

Depreciation Rates and Practice—Specific Suggestions

In the pages which follow, information[32] is given which is intended to serve as a guide in deciding in what cases and at what rates depreciation shall be charged. The topics, which are arranged in alphabetical order, deal in some cases with specific objects or classes of objects and in other cases with types of enterprises. The list is not intended to be and obviously cannot be complete. The variations of the rates in some of the cases given indicate the futility of trying to set uniform rates applicable to given objects under all conditions.

The theory of depreciation is that there should be a return of the investment by the end of the useful service life of the asset. The rate should be fixed accordingly.

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[32] The general sources are, for American practice, *Auditing, Theory and Practice* (3rd edition), by R. H. Montgomery, pages 621-654; and for British practice, *Income Tax Practice,* by Murray and Carter.

Contrary to the practice in this country the British Treasury arrives at definite agreements with taxpayers regarding the general rate of deprecia-

tion which shall apply in various industries. The following table gives the latest available list of British "agreed rates of depreciation" (see "The Taxation of Excess Profits in Great Britain," by Robert Murray Haig, *The American Economic Review,* Supplement, December, 1920):

SCHEDULE OF AGREED RATES OF DEPRECIATION

Industry, &c.	Per cent	Prime Cost or Written-down Value	Nature of Plant
Electric Light Undertakings	3 5	Written-down Value " "	Cables. Plant and machinery.
Flax Spinning and Linen Weaving (Ireland)	7½	Written-down Value	Machinery and plant (except accessory plant such as pirns, pirn cages, spools, belting, driving ropes, damask cards, designs, patterns, models, furniture and fixtures).
Flour Milling	5 7½	Written-down Value " "	Engines, boilers and main shafting. Other machinery.
Gas Undertakings other than those owned by municipal or other public authorities	3 10	Written-down Value " "	Gasholders. Meters, cookers and gas fires.
Motor Omnibuses[1]	20	Written-down Value	Motor omnibuses.
Paper Mills	5 7½	" " " "	Machinery working day only. Machinery working day and night.
Printing	5 7½ 10	Written-down Value " " " "	Engines, boilers and shafting. Printing and binding machines. Type.
Railway Wagons[2]	5	Written-down Value	Railway wagons.
Shipping[3]	4 3	Prime Cost. Prime Cost.	Steamships. Sailing vessels.
Steel Manufacturers[4]	15	Written-down Value	Machinery and plant used in the manufacture of steel.
Timber Merchants, Saw Millers, and Manufacturers of Timber Goods	5 7½ 20	Written-down Value " " " "	Engines, boilers, main shafting. General saw-milling plant and machinery. Traction engines, tractors, motor-cars, and haulage plant.
Tramways[5]	— 3 7 5	— Written-down Value " " " "	Permanent way. Cables. Cars and other rolling stock. General plant and machinery, including standards, brackets, and work-shop tools.

[1] The rate of 20 per cent is to be re-considered at the expiration of four years commencing with 1916-17. This rate does not apply to commercial motor vehicles.

[2] The allowance applies to all wagons owned by traders. In the case of railway companies the method adopted is to allow the actual cost of renewals year by year.

[3] With regard to ships *purchased at secondhand* at prices in excess of the written-down value at the date of purchase, the following arrangements have recently been made:—(*a*) The allowance is made on the actual cost price of the ship to the owner for the time being without regard to the prime cost to a previous owner. (*b*) The rate of depreciation allowable is calculated by reference to the reasonable expectation of the life of the ship at the date of purchase from the previous owner.

[4] The rate of 15 per cent represents 5 per cent for normal wear and tear, and 10 per cent for the additional wear and tear arising from war conditions.

[5] An allowance per mile of track based upon the estimated life of the permanent way.

Alterations and improvements.—In some cases alterations are charged as an expense, being regarded as in the nature of repairs.[33] This practice is not always correct. Many alterations are in the nature of improvements, and improvements are capital expenditures. This is the position taken by the Treasury as is shown by the following quotation:

REGULATIONS. No deduction from gross income may be made for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property, or for any amounts expended in restoring property or in making good the exhaustion thereof for which an allowance for depreciation or depletion or other allowance is or has been made, ... (Art. 581.)

. . . . (3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. (Art. 24.)

The author reiterates his advice that liberal allowances should be made for repairs and depreciation, and that no expenditures should be charged to capital if there is any doubt about the items. Sometimes so-called alterations may properly be charged off as a necessary expense of the business. If so, some name other than alterations should be found for the expense.

RULING. Expenditures by a taxpayer in altering a building to conform to a street widening, which alteration does not increase the value of the building, constitute a business expense for the year in which such expenditures are incurred, deductible only in the return of net income for that year, and any division of such deduction so as to spread the same over the returns for a period of years, whether called a depreciation charge or otherwise, is unauthorized. (Bulletin "F," page 8.)

If the expenditures in such cases are substantial or exceed

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[33] DECISION. (Syl.) "Amounts expended by a business corporation in enlarging or making improvements in its office or premises, not in the nature of permanent improvements to the property, but to facilitate the transaction of a growing business, should properly be deducted as necessary expenses of the business." (*Connecticut Mutual Life Insurance Co. v. Eaton*, 218 Fed. 206; affirmed, 223 Fed. 1022.)

the income or if the alterations make the building unusable for a considerable period, it is possible that the cost should be capitalized. Any damages collected would be an offset against the cost.

Apartment houses.—See "Buildings" (below).

Automobiles.—Under ordinary conditions the rate of depreciation on automobiles should be fixed at not less than 20 per cent per annum. This rate has been adopted by the tax commission of one of the states. The *Primer* states that "the estimated lifetime . . . . of automobiles used for business or farm purposes and farm tractors" is "four to five years."[34] A rate of depreciation based on an estimated life of three years may not be excessive if adequate provision is made for residual value. In the oil industry the Treasury allows 33⅓ per cent.[35]

While five years may appear to be a high estimate for the life of the average automobile it must be remembered that the nature of the asset permits repairs to be made on so extensive a scale as to reduce materially the necessity of complete renewals. Tires are frequently renewed, motors are replaced and in some cases (e.g., the taxicab companies) bodies are entirely rebuilt. Depreciation, therefore, as distinct from repairs and renewals, may be a smaller factor than appears at first glance. Of course, full allowance must be made for "accrued" wear and tear.

In some cases estimates of depreciation are based on mileage:

The second illustration, supplied by a manufacturer of metal products, indicates that an estimate of depreciation based on expected performance can become very exact. This company calculates its depreciation on Ford cars used by its salesmen at 2 cents a mile and reports that the last thirty cars sold, exchanged or scrapped showed

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[34] *Income Tax Primer,* 1918, question 99.

[35] *Manual for the Oil and Gas Industry* (revised August, 1921), page 64.

an average depreciation of 1.9 cents per mile and that these thirty cars were operated between five and six hundred thousand miles.[36]

REGULATION. . . . . No such allowance may be made in respect of automobiles or other vehicles used chiefly for pleasure, ... (Art. 162.)

Books—business and professional.—The Treasury rules that the cost of professional books is not a business expense but is an investment of capital against which depreciation may be charged.[37] Roughly speaking, books in a technical library depreciate at a rate sufficiently rapid to justify charging off the total year's purchases in the case of libraries which are being kept up to date. This obviates the necessity of an annual revaluation of the library.

This plan has been approved by examiners who have satisfied themselves that the deduction for new books did not exceed reasonable depreciation on the entire library.

Buildings.—Obviously no general rate applies to buildings, since methods of construction, materials used, purposes, etc., affect the wear and tear incident to use. In a case relating to depreciation of apartment houses, the government allowed 3 per cent (see below). Perhaps this was a fair rate under laws which excluded the factors of inadequacy, change in character of neighborhood and other items of obsolescence. Under the 1921 law[38] obsolescence must be taken into consideration. Three per cent is the rate frequently used by manufacturers for slow-burning brick structures; and 2 per cent is the minimum rate for concrete, brick and steel fireproof structures. Perhaps 2½ per cent is more nearly correct. Where walls are subjected to unusual strain or vibration, a rate of not less than 4 per cent should be used.

In a state in which the subject has been carefully studied, a

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[36] *Depreciation—Its Treatment in Production*, Chamber of Commerce of U. S., October 15, 1921.

[37] Bulletin "F," page 11.

[38] Obsolescence was first allowed under the 1918 law; see page 1130.

rate of 2 to 2½ per cent for cement or brick buildings and 3 to 5 per cent for wooden buildings has been adopted.

The National Machine Tool Builders' Association uses these rates: brick buildings, 3 per cent; frame buildings, 5 per cent.

The Treasury states:

RULING. A frame building may remain serviceable for a period of 20 to 30 years, while a building of steel, concrete, and stone construction may have a life of 50 to 100 years. (Bulletin "F," page 7.)

In the case of an apartment house the jury found that 3 per cent was a proper rate of depreciation.[39] This was the rate allowed by the government, while the plaintiff claimed 5 per cent. The apartment house is situated at No. 320 West 84th Street, New York, a very desirable location. The jury was, of course, influenced by the charge of the court, which was in part as follows:

There is no question that the plaintiff was entitled to a deduction for wear and tear of this building, and the government allowed him, I believe, 3 per cent—he claims 5 per cent—and the question for you to determine is whether he is entitled to any greater allowance for depreciation over and above what the government allowed him, which is 3 per cent.

The burden would be upon him reasonably to satisfy you from the evidence that he was entitled to an allowance of an amount greater than 3 per cent in order to obtain that allowance because, as I say, he is the plaintiff asserting the claim. . . . .

The allowance is for wear and tear when it relates to a building . . . . that means the physical deterioration that a building suffers during the tax year; it does not include the depreciation in value due to a loss in rental value, because of modern buildings going up with better facilities than the old building had—that is not the idea.

The Treasury takes the following general position on the question of depreciation, which applies particularly to the case of buildings:

REGULATION. . . . . No modification of the method should be made on account of changes in the market value of the property from time to time, such as, on the one hand, loss in rental value of the buildings due to deterioration of the neighborhood, or, on the

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[39] *Cohen v. John Z. Lowe, Jr.*, 234 Fed. 474 (1916).

other, appreciation due to increased demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimated useful life of the property. (Art. 166.)

The foregoing regulation refers exclusively to depreciation. When change in the character of a neighborhood or other causes result in an ascertainable loss the claim for depreciation (which now includes ordinary obsolescence) should be correspondingly increased.[40]

Buildings under construction.—When buildings, particularly factories, are partly completed the question arises as to the date from which to compute depreciation. In most cases the construction account is not closed until the building is entirely completed, even though a considerable portion of it may have been in use for some time. It has been suggested that the depreciation should be based upon an average date, except in cases in which depreciation could not be said to commence until actual completion.

The same reasoning would apply to items other than buildings, such as storage tanks, etc., which are carried in construction account until a group of units is completed. Accounting practice, however, requires that all costs of construction be capitalized until operations commence; therefore the allowance for depreciation on an uncompleted plant, no part of which is in use, would be debited and credited to the same account.

Ruling. The term "useful life" as used in article 161, Regulations 45, is interpreted to mean the period of time over which an asset may be used for the purpose for which it was acquired. In the case of a new building, this period starts at the time the building is completed and capable of being used. Buildings under construction are not subject to a depreciation allowance for income tax purposes. (C. B. 4, page 178; O. D. 845.)

The foregoing ruling is broad enough to include cases in which a building may be partly occupied before being en-

[40] For full discussion of obsolescence of buildings, see page 1140.

tirely completed. In such cases partial depreciation should be computed from the date of such partial occupancy.

The following extracts from a recent address by a recognized authority on real estate and buildings emphasize the need for special study of each particular case.[41]

The principal reason that depreciation was never considered as an important question up to the time that the fireproof building came into existence was a settled belief that New York land values would always increase not less than 2% per annum and many such owners as O. B. Potter declared that there would never be a time when well-located New York real estate would not increase 2% in value every year. For this reason they felt perfectly contented to let their buildings run down on the theory that sooner or later a better class of building would be required and that there was no profit in making substantial outlays for the maintenance of old buildings.

When it was found that New York real estate could depreciate in value much faster than it had appreciated, the problem of depreciation began to demand respectful attention.

When we ask what is the probable length of life of a modern building it is like asking an insurance examiner what is the probable life of a man. The insurance examiner replies "tell me the history of the man, of his father and mother, of his habits, of his occupation his physical condition, and I will tell you, barring accidents, what his probable life will be." In considering the probable life of a steel structure or of an ordinary building, the problem must be approached in the same way. Who built the building? Who maintains it? How were its foundations laid? What is its use? To attempt to sum up the problem of depreciation for any building requires that we take into consideration, first, the design of the building and of its foundations; second, the type as adapted to its locality and purpose; third, its construction and material; fourth, its operation and maintenance.

Anyone who attempts to pass judgment without this information is merely guessing in the dark. As an illustration of what I mean, take the case of a hotel, 10 stories, 50 x 100, built in the very finest way at a cost of $225,000 by an experienced investor and apparently good for a life of 40 years. It is located at 157 W. 124th St.

This splendid building depreciated so fast that it had to be destroyed as a hotel in seven years. Why? Because it was misplaced and was a failure. It cost $50,000 to convert it into a storage warehouse and it became a perfect building and good for perhaps 50 years for this purpose, provided it is reasonably maintained. But suppose it is neglected and abused, its automobile elevator allowed

[41] "Depreciation of Buildings," by Frank Lord, vice-president, Cross & Brown Co., New York City.

to wear out and no repairs made to keep it up to a reasonable standard of usefulness, how much can its natural life be shortened? The building, — West — Street, was worth $48,000 one year ago. The tenant spent $9,000 on it and it is worth $72,000 today or 50% appreciation.

Who is to judge of these conditions and what is his judgment worth and who will accept it? If we say that the life of a hotel is 30 years; of an office building 40 years; of a loft building 50 years; of an apartment house 25 years, of a non-fireproof structure, or a mill construction 35 years, who is to successfully contradict us and on what conditions of use or abuse, of care or neglect, of bad management or wise management, is all this to be decided? In my opinion, the plan of estimating 2½% on the mortgage is another way of guessing on broad general lines because in every case land value is part of the mortgage and leaves haphazard the proportion the building represents.

Look at the beautiful Blair Building at 24 Broad Street and ask me how much this superb building in a superb locality with a generous upkeep will depreciate and I will reply that a structure under such ideal conditions may last for 60 years not only because its design and construction are ideal, but its owners are ideal. The same may be said of the new Stock Exchange and the Bankers Trust Building opposite, but when you have named 20 or 25 buildings downtown and a dozen uptown, headed by the U. S. Rubber Building, you have exhausted the list of preferred risks and there are all sorts of grades and conditions to be classified. I do not say that they can not be properly classified and a reliable grading arrived at, for purposes of estimating probable depreciation, but as a practical question, the labor and cost is too great and in the end it comes back to definite considerations to be weighed for each building as to its birth, life and history coupled with engineering knowledge and judgment, and summed up by real estate experience and honest appraisal.

In the absence of this kind of knowledge and appraisal, we must be content to accept the method generally adopted of taking 3% for brick and stone and 4% for frame buildings as a fair measure of depreciation, and where the danger signals are flying adapt our own judgment to each particular problem.

The most pronounced cause of loss in real estate has been the failure of owners to set aside each year 3 to 5% of their income to make extraordinary repairs and to replace worn out buildings. When they find their income reduced to the vanishing point, they consult their lawyers who in turn consult some chance real estate broker who advises a sale for land value. The property is sold to some wise speculator who remodels it at a third of its original cost and rents it to such advantage that it pays better than ever before, proving that

the depreciation that wiped out the former owner's equity was the depreciation of bad management and neglect.

For fully 20 years I have been advising investors to put 5% of their net income into a sinking fund to meet this problem, and one investor who had adopted this practice told me that one property had paid for itself out of surplus earnings above 7% on his invested capital.

If I asked this gathering what Bethlehem Steel shapes were and their difference from fabricated steel and what effect they had on the cost and on the life of a building probably not one quarter of those present could answer. Yet nothing could be more instructive than to have one of Mr. Schwab's young engineers spend an hour with us in describing the Bethlehem process and what it means to building construction. Another unknown factor in large buildings is whether they are wind braced or not.

There are many such factors in the constitution of a building buried securely from sight which go to the heart of the matter, and a life insurance examiner might as well try to pass an applicant by looking at him and talking politics with him as for one of us to decide conclusively what should be the depreciation of various types of structures from such general knowledge as may be obtained without careful investigation of a good builder and a capable engineer, coupled with experienced real estate judgment of the probable fitness of the building for the future and who its owner and manager is to be.

Cash registers.—The average life of a good cash register is from ten to twenty years, although some are in use to-day which were sold more than twenty years ago. The reduction in value during the early years is heavy, as with typewriters, and machines are frequently exchanged. This is due to inadequacy more than to depreciation. If an annual rate is to be constant over the expected effective life of the machines, it would be unwise to fix it at less than 15 per cent.

Chemical industry.—In the chemical industry buildings depreciate about 2½ to 3 per cent. The machinery and equipment depreciation depends largely upon the nature of the product manufactured, the average being about 15 per cent.

Containers.—In certain kinds of business, such as breweries, milk depots, spring-water distribution, bakeries, etc.,

considerable numbers of containers, such as casks, kegs, bottles, cases, cracker tins, etc., are owned, which are used principally for convenience of transportation and are supposed to be returned when empty. As to these, no specific rate of depreciation can be fixed. Each case must be considered on its merits. Rates given in the table on page 1123 are suggestive of good practice.

At balancing time an accurate inventory should be taken, if possible, but if not practicable, it will be necessary to make a calculation as to the number required for the normal operation of the business. An inspection of the reserve supply will serve as a check on the book valuation. In many cases concerns go on the assumption that all such containers are in possession of someone who will in due course return them, but experience proves that considerable numbers are lost, broken or stolen, and that to carry these as stock on hand is inaccurate.

Contracts.—The Treasury now recognizes the position which the author has held for several years, viz., that any kind of property, tangible or intangible, may be amortized, depreciated or depleted either on the basis of market value at March 1, 1913, or upon cost since that time. The regulations are quite as liberal as could be desired.[42]

If an automobile dealer secures a valuable contract from a manufacturer, and turns it over to a corporation, the latter may claim as a deduction the cost of the contract spread over its life; but in this case as in all other similar cases the corporation cannot claim the deduction unless the payment for the contract was made in good faith and for proper consideration, and where there was any community of interest between the dealer and the company, the former would be compelled to return as taxable income the purchase price of the contract which the corporation claims to have paid to him.

[42] Art. 163; see page 1097.

Copyrights.—Copyrights may be charged off under the same procedure as patents, except that the term is 28 years, which term, under certain circumstances, may be renewed for another 28 years. As most copyrights diminish rapidly in value, depreciation should not be based on their life. Revaluation of each one is the only satisfactory solution. A list of copyrights owned should be compiled. Inquiry based on this list will develop evidence as to the actual worth of the asset. The Treasury is attempting to base the depreciation on cost or March 1, 1913, value spread over the term of the copyright or the life thereof remaining after date of acquirement or March 1, 1913.[43]

RULING. . . . . It is further held that depreciation of a patent or copyright acquired prior to March 1, 1913, can be taken on the basis of the market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered and, in the absence of such evidence the depreciation allowance must be based upon the cost. . . . .

Held also, that in view of the foregoing and in accordance with article 167 of Regulations 45, the annual allowance for depreciation of the copyright should be computed by an apportionment of the cost of the copyright over its life since its grant, and such cost must be limited to the author's actual capital outlay in securing the copyright, including the actual cost to the author of produicng the book covered by the copyright, but not including any amount representing the value of the author's own time and labor. (B. 27-21-1721; O. D. 966.)

Costumes—theatrical.—

REGULATION. . . . . properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.[44] (Art. 162.)

If adapted for "occasional" personal use, claim for depreciation is still allowable, but consideration must be given to the value of the personal use, depreciation in regard to which is not deductible.

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[43] Art. 167.
[44] See page 868.

Electrotypes, woodcuts, etc.—The arguments urged in case of patterns (see page 1114) apply with equal force to electrotypes, woodcuts, etc. Conservative publishers charge off almost the entire cost of plates as a direct cost of a first edition and are careful to revalue the balance of the account frequently. If a book or other publication is successful, the cost of plates, etc., can be readily absorbed in its cost; but if it is not successful, no new orders can be expected and it would be folly to carry the plates on the balance sheet at *any* valuation except as scrap metal. A number of bankruptcies have occurred in the publishing business through disregard of this principle.

Formulas.—

Ruling. Formulas are not a character of property subject to annual depreciation deductions in a taxpayer's return; however, if after acquisition, a formula is found to be worthless, its cost may be charged off in toto in the taxpayer's return for the year in which its worthlessness was discovered. (C. B. 3, page 169; A. R. R. 339.)

Foundries.—Depreciation does not average more than 4 per cent on foundry buildings. Depreciation on foundry equipment, with the exception of flasks, patterns and core boxes, should average not more than about 5 per cent; while on the articles mentioned the rate should range from 10 to 20 per cent. A high rate is necessitated by the fact that many patterns become obsolete because they are made in an experimental way.

Furniture and fixtures.—Furniture and fixtures have little residual value, and conservative concerns charge off by far the larger proportion of the cost. In most establishments many items, such as partitions, special shelving, etc., are charged to the fixture account. When frequent alterations and changes are made, most of such expenditure is in the nature of repairs and should be charged off at the time. If charged to an asset account, it should be distributed ratably over a few years' operations.

If it is important to write off actual depreciation only, it will be found that 15 per cent per annum represents a fair average allowance. The tax commissioner of one of the states has adopted a standard rate of 10 per cent, but in exceptional cases allows as much as 25 per cent.

Usually in a going business, assets are not treated on the basis of realization values, but in the case of furniture and fixtures so many changes are made to suit the convenience and whims of executives and clerks, and offices are moved so often from one place to another, that these assets have a most uncertain value.

Leaving out of consideration the complex question as to what are and what are not landlord's fixtures, it may be laid down as a general rule that the minimum rate of depreciation upon machinery and fittings erected upon leasehold property should be sufficient to wipe off the book value before the expiration of the lease. In the case of machinery, etc., which will not become landlord's fixtures, a less rate may be permitted, but it is imperative that in such a case it be clearly understood and agreed what are to be the landlord's fixtures and what are not.

Goodwill.—No claim for depreciation, as such, of goodwill, trade-marks or trade-brands should or will be allowed, but when goodwill was purchased or had a value March 1, 1913, and later declines in value on account of such causes as state or national prohibition, depreciation in the nature of obsolescence will be allowed.[45]

Regulation. Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises.[46] Intangibles, the use of which in the business of trade is

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[45] See page 1144.

[46] **[Former Procedure]** In the preliminary edition of Regulations 45 among the examples of intangibles subject to depreciation was "limited leases." The item was omitted in the April 17, 1919, edition and in the amendment of October 7, 1919. The omission of the restriction on an allowance for goodwill, etc., arises out of an allowable deductions for obsolescence of goodwill, etc. See page 1132.

not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. (Art. 163.)

The regulation fails to state that the value of the property at March 1, 1913, is subject to depreciation even though the asset was not acquired by capital outlay.

Hat factories.—The depreciation on hat factory buildings is about 2½ per cent; on equipment from 4½ to 10 per cent; while on the molds used in the business it is the same as on the patterns in a foundry.[47]

Horses.—Horses become less valuable not only through age but also through hard usage. If depreciation is calculated on an annual percentage basis, the allowance should usually be from 10 to 25 per cent of the cost. The alternative method of basing depreciation on periodical revaluations is favored by many because it makes possible a closer approximation of actual deterioration. Certainly, in the case of horses, valuations can be established more accurately than in the case of most assets. Fairly frequent revaluations are therefore desirable.

Intangible property.—Intangible property is held to be subject to depreciation and obsolescence. (See discussion under "Leaseholds," page 1099 and "Goodwill," page 1097.)

Land.—The regulations deal with depreciation in the value of land as follows:

REGULATION. . . . . The allowance . . . . does not apply . . . . to land apart from the improvements or physical development added to it.[48] . . . . (Art. 162.)

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[47] See pages 1088 and 1114.
[48] See Chapter XXXIII, "Deductions for Depletion."

Generally speaking, land does not depreciate. Declines in values are not allowable deductions until sales are made, at which time the resulting losses may be deducted as losses, and not as depreciation. But if it can be shown that depreciation, as the term is used in the law, actually occurs in land values, credit may be claimed, even though the foregoing regulation would seem to indicate otherwise.

The law[49] permits "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business."

It would therefore seem that if land which is used in the business of farming depreciates in value because of its employment, and not because of fluctuations from other causes, credit may be claimed therefor.

If a farmer were to produce successive crops from his land without being able to restore the land to its former fertility it would be inequitable to compel him to return for taxation the value of the crops produced and prohibit the taking of credit for one of the chief items of cost of production—and depreciation in the value of land due to exhaustion can hardly be called anything but an operating cost.

Declines in values due to erosion may more properly be dealt with as losses, but the law seems to have specifically provided for depreciation due to exhaustion.

Leaseholds.—No mention of leaseholds is made in the 1916, 1917, 1918 or 1921 income tax laws. Because of the importance of this class of assets the Treasury has issued comprehensive regulations dealing with its treatment. Many kinds of property are operated under leases which may be held or sold to others. A leasehold becomes the personal property of the lessee or purchaser. Its value or cost is an integral part of his investment. The owner uses or employs the property until its value is exhausted.

REGULATION. Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his re-

[49] Section 214 (a-8).

turn an aliquot part of such sum each year, based on the number of years the lease has to run. . . . . (Art. 109.)

By reason of the temporary character of a leasehold its cost may be amortized during the term of its life from the date of purchase or from March 1, 1913, so that an equal portion of its cost or of its value on March 1, 1913, shall be charged against the operations of each year.

A leasehold is property. Section 325 (a) of the 1921 law specifies leaseholds as tangible property for the purpose of the excess profits tax law. Neither can it be denied that a leasehold loses its value by the mere effluxion of time. Consequently it is not only proper but necessary that its amortization be recorded on the books of its owner.

In a ruling of the Committee of Appeals and Review the nature of a lease is well described:

RULING. . . . . The facts appear to be that this company was organized with a small amount of capital stock, none of which was paid up, and later it secured a lease to wharf property, no bonus being paid for the lease. The business of the company is the subletting of this leased property.

It is clear that the income of the company is derived chiefly from the possession of a capital asset which is not capital in name only, but a real tangible asset, to wit, its lease upon the wharf property. . . . . (C. B. 3, page 341; A. R. R. 315.)

DEPRECIATION ALLOWED LESSEE.—

RULING. Ordinarily an allowance for depreciation may be taken only on account of property owned by the taxpayer and used in trade or business and may not be taken on account of property of which he is merely the lessee. This will not preclude the deduction each year by the lessee of an aliquot part of the cost or the bonus paid for the lease. In the case of additions, improvements, or betterments to the property made at the expense of the lessee, which, according to the terms of the lease, revert to the lessor at the termination of the lease, the lessee may apportion the cost of such additions, etc., over the life of the lease and deduct an aliquot part thereof each year. If, however, the life of improvements for business purposes made at the expense of a lessee is less than the life of the lease, depreciation may be taken by the lessee instead of treating the cost

as additional rent.[60] Stockholders of a corporation are not entitled to deduct in their individual returns any amount on account of depreciation of the property of the corporation from which they receive dividends. (Bulletin "F," page 32.)

The foregoing covers only the period subsequent to March 1, 1913. When a lease executed prior thereto had an ascertainable value on that date the value is capital and may be returned to the lessee free from tax. This principle is recognized in the following ruling.

VALUE OF LEASE AT MARCH 1, 1913, MAY BE USED FOR DEPRECIATION PURPOSES.—

RULING. The M Company obtained a lease in 189— covering a period of 99 years, for which it pays nothing except the stipulated annual rent. The question raised is whether the company may set up the value of said lease as of March 1, 1913, and charge off depreciation over the remaining term of the lease.

In the case of a lease held by the original lessee, who acquired it prior to March 1, 1913, without any payment other than a stipulated annual rent, the presumption is that the lease had no value as at March 1, 1913. Under this presumption there is no basis for a depreciation deduction. This presumption can be overcome only by evidence showing conclusively that the lease had a value as of March 1, 1913, for depreciation purposes. There is no prescribed method by which the value of a lease as of March 1, 1913, in excess of its presumptive value as at that date may be established. The burden is upon the taxpayer to establish the basis for depreciation to the satisfaction of the bureau. (C. B. 3, page 145; O. D. 720.)

In many cases evidence regarding the value of a lease on March 1, 1913, can be readily secured.

WHEN LESSEE MUST RETURN PROPERTY UNIMPAIRED.—

RULING. The M Company leased to the O Company certain street railway properties.

By the terms of the lease the lessee is required to return the leased properties to the lessor at the end of the lease in the same condition they were in at the date of the lease.

All of the stock of the lessor company is owned by the lessee company. Inquiry is made whether for Federal income tax purposes,

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[60] For obsolescence of improvements on leased land, see Chapter XXXII.

the lessee company may charge depreciation of the leased properties on its books.

Held, that inasmuch as the properties leased must be returned to the lessor company at the end of the term of the lease in the same order and condition as they were in at date of lease, there will be no depreciation of such properties while in the lessee's possession and therefore no deductions by the lessee for depreciation will be allowed. Amounts expended to keep the properties in good condition and repair are deductible as business expenses in the returns of lessee corporation for the years in which such amounts are expended. (B. 35-21-1794; O. D. 1014.)

The foregoing ruling is not sound. Assume that before the end of the lease a large part of the equipment is scrapped in a single year because it has worn out. The lessee would have to replace it. The Treasury would not permit the replacement to be charged to income as "repairs." Although depreciation actually accrues year by year, the Treasury under the ruling would deny the deduction, and neither the lessee nor lessor would get the benefit clearly provided by the law. This reasoning is based on the fallacious theory that repairs and maintenance offset depreciation.[51]

Machinery and equipment.—While specifically declaring that "each taxpayer must determine the probable lifetime of his property without regard to the . . . . figures given," the *Primer* makes the statement that "the estimated lifetime of ordinary machinery is ten years."[52]

So many factors affect the length of the life of machinery that the only satisfactory solution is to assign to each machine its own individual rate of depreciation. What that rate shall be must be determined by experience with similar machines in similar circumstances. These circumstances vary widely. Two machines exactly alike in the beginning may show a considerable difference in length of life and service when installed in different plants. An uneven or unstable foundation may shorten the life of one machine. Cleanliness and lubrication,

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[51] See page 1059.

[52] *Income Tax Primer*, 1918, question 99.

care and skill in operation and continuity of service are important factors. Climatic conditions often enter to complicate the problem, machinery in some sections of the country deteriorating more rapidly from this cause than in other sections. Again the policy relative to repairs and maintenance affects aggregate renewal costs. A high standard of upkeep means lower depreciation rates. Often a considerable part of the ordinary wear and tear for which depreciation reserves are created is charged to operating expenses in the form of repairs and maintenance. Small parts of machines are constantly wearing out or breaking and are being renewed as an expense. Sometimes nearly every part of a machine is renewable and in such a case it is quite conceivable that at the end of five or six years the machine may be so largely renewed as to be about as good as new. Where a condition of this sort exists the depreciation rate should be lowered.

It is apparent that no hard-and-fast rule can be laid down. The nearest possible approach to a general rule is to state that in addition to charging all repairs and part renewals to operating expense, from 7½ to 12½ per cent should be written off annually from the original cost to provide for normal depreciation. When double shifts are made necessary the rate is increased. In certain cases engineers have estimated that the increase in rates due to overtime and "diluted labor" is from 50 to 100 per cent.

In the case of a heavy machine tool the life is usually considered to be from fifteen to twenty years, ignoring the question of obsolescence; yet the rate of the National Machine Tool Builders—which is 10 per cent and is for favorable conditions and applies to the total original value and not to a decreasing value—should be given weight.

It is invariably desirable that a subsidiary ledger be kept containing details not included in the machinery accounts of the general ledger. Such detailed records not only assist in the calculation of rates of depreciation but they are also of

great value in determining the amount to be written off in case of a sale or fire[53]

Mine equipment.—A company mining bituminous coal claimed depreciation on the following basis:

Mine equipment	6 2/3%
Power houses and machinery	6 2/3
Tipples, inclines and screens	6 2/3
Saw mill	6 2/3
Tenement houses	5
Buildings and other houses	5

The inspector refused to allow the deduction because the depreciation was not entered on the books, but on appeal to Washington the rates were passed as reasonable. In this case, the quantity of coal in the ground was sufficient to warrant writing off depreciation on an estimated life of twenty years. The quantity of unmined coal must always be taken into consideration.

Regulations. (*a*) All expenditures for development, rent, and royalty in excess of net receipts from minerals sold shall be charged to capital account recoverable through depletion, while the mine is in the development stage. Expenditures made in order to maintain the mine at its normal output shall be deducted as an expense in the year in which the expenditure is made or accrues. Any expenditure for extraordinary development and equipment, such as stripping, shaft sinking, tunneling, and other work beyond that necessary to maintain the mine at its normal production or output should be carried forward and apportioned and deducted as an operating expense in the years to which it is applicable.

(*b*) All expenditures for plant and equipment shall be charged to capital account recoverable through depreciation, while the mine is in the development stage. Thereafter the cost of major items of plant and equipment shall be capitalized, but the cost of minor items of equipment and plant, necessary to maintain the normal output, and the cost of replacement may be charged to current expense of operation. . . . . (Art. 222.)

[53] In a well-known English compilation, the depreciation rates of "American-made" machinery are from ¾ of 1 per cent to 2 per cent higher than on the same class of machinery manufactured in England. No explanation is given. This is of interest when quotations from English reports or decisions are used as precedents.

(*a*) The Act provides that deductions for depreciation of improvements "according to the peculiar conditions in each case" may be taken by a taxpayer owning or leasing mining property. This is deemed to include exhaustion and wear and tear of the property used in mining of deposits, including a reasonable allowance for obsolescence . . . .

(*b*) It shall be optional with the taxpayer, subject to the approval of the Commissioner, (1) whether the value of the mining property plus allowable capital additions but minus estimated salvage value shall be recovered at a rate established by current exhaustion of mineral, or (2) whether the value of the mineral deposit on the basic date plus allowable capital additions shall be recovered through depletion and the cost of plant and equipment less the estimated salvage value shall be recovered by reasonable charges for depreciation at the rate determined by its physical life or its economic life or, according to the peculiar conditions of the case, by a method satisfactory to the Commissioner.

Estimated physical life.—

(*c*) The estimated physical life of a plant or unit thereof (including buildings, machinery, apparatus, roads, railroads and other equipment and improvements whose principal use is in connection with the mining or treatment or other necessary handling of mineral products) may be defined as the estimated time such plant, or unit, when given proper care and repair, can be continued in use despite physical deterioration, decay, wear and tear.

Estimated economic life.—

(*d*) The estimated economic life of a plant or unit thereof is the estimated time during which the plant or unit may be utilized effectively and economically for its intended purposes and may be limited by the life of the property or of that portion of the mineral deposits which it serves but can never exceed the physical life.

Adjustment of depreciation reserves.—

(*e*) Any difference between the salvage value of plant and equipment and the depreciated value remaining at the termination of mining operations shall be returned as profit or loss in the year in which it is realized.

Salvage value of equipment.—

(*f*) Nothing in these regulations shall be interpreted as meaning that the value of a mining plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been

abandoned for the purpose of mining. In estimating the salvage value of the equipment at the end of its estimated economic life due consideration may be given to its specialized character and the cost of dismounting and dismantling and transporting it to market.

LAND MAY NOT BE DEPRECIATED.—

(*g*) Nothing in these regulations shall be interpreted to permit expenditures charged to expense in any taxable year or any part of the value of land for purposes other than mining to be recovered through depletion or depreciation. (Art. 224.)

EXPENDITURES WHICH BENEFIT THE FUTURE.—It is claimed by many competent mining engineers that good practice in the mining industry permits the charging to maintenance of expenditures for improvements the benefits and advantages of which extend over a period of years. Under ordinary accounting practice all expenditures which benefit the future should be set up as deferred assets and allocated to the succeeding periods which realize the benefits.

The recent federal tax laws recognize that general principles may be modified in a trade or business. When the modifications are accepted as controlling and as good practice by a majority of concerns in such industry, general principles are superseded. The custom of charging improvements to maintenance does not extend to original development and equipment, but is limited to expenditures which are made after mines are in operation. The theory is that after operations have begun practically all so-called improvements "are really nothing but expenses required to keep the property from depreciating."[54]

DEVELOPMENT COSTS.—Under article 223, a taxpayer is given the option of charging to expense or capitalizing exploration expenditures, "drilling of wells, building of pipe lines, and development . . . ." The election once made is held to be binding in subsequent years.

RULINGS. A corporation which in 1916 and 1917 exercised its option and charged to capital account such expenditures as wages,

[54] J. R. Finlay, *The Cost of Mining*, page 65.

fuel, repairs, hauling, etc., in connection with the exploration of property, drilling of wells, etc., may not subsequently amend its returns covering such period so as to transfer such items to operating expenses to accord with their treatment in its 1918 return. (C. B. 4, page 199; O. D. 796.)

Held, that under article 223, Regulations 45, the exercise by a taxpayer of his option to charge cost of drilling wells to operations precludes a revision of the accounts to treat such items as capital expenditures. (C. B. 4, page 200; A. R. M. 110.)

Where a parent company which owns the stock of a subsidiary company elected under article 223, Regulations 45, to charge as operating expenses, the expense incurred by it during the period in which it operated oil leases, the subsidiary company, to which the oil leases were sold, is bound by the election of the parent organization and must charge development and exploration expenses made by it in connection with such oil leases and properties to operating expenses. (B. 34-21-1781; O. D. 1002.)

In permitting items, which are ordinarily regarded as capital to be charged to expense, the Treasury recognizes the hazardous character of the oil industry.

Depreciation of equipment of oil and gas wells.—

Regulation. Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion or as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost (or fair market value as of March 1, 1913, if acquired prior to that date) equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit. . . . . (Art. 225.)

Detailed classifications of both oil and gas well equipment and the rates of depreciation applicable thereto have been

published by the Treasury.[55] So far as is known this is the only industry for which the government has officially suggested classifications and rates.

The Treasury suggests that well equipment be depreciated at the same rate as that at which the oil or gas reserves are depleted. The reason for this method in preference to a straight line rate of depreciation such as 10 per cent a year, is that after a well has produced for a few years there is practically no salvage value to the casing and tubing. Casing and tubing are the large and small sizes of pipe which are put into a well to protect the oil or gas from physical encroachments in its passage from the producing sand to the mouth of the well.

If a well has produced for five years, under ordinary circumstances the casing and tubing would be useful for several years more if left in the well and the well continued to produce. If the well ceases to produce and the casing and tubing are pulled out, they may not be in such a condition as to warrant the expense of transporting them any distance, especially over a rough country, and putting them into another well for the remainder of their life. Furthermore, the operations of pulling out casing and putting it down into a well are hazardous both as to the expense which may be involved and the risk of injuring the material. The recommendation of the Treasury to depreciate the well equipment at the same rate as the mineral contents are depleted is reasonable.

There may be circumstances under which this method of depreciation will not apply. Some producers pull the outer casing as soon as a well begins to produce, and use it in pipe lines or other wells. When the newly drilled well turns out to be a dry hole, that is, it produces no oil or gas, probably all the casing and tubing will be pulled. Equipment rapidly deteriorates under these conditions. In these instances the rate recommended by the Treasury will not apply, and the

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[55] *Manual for the Oil and Gas Industry*, 1921, page 63.

equipment must be depreciated at a high rate for the period during which it has been in the well.

Orchards.—See page 1414.

Organization expenses.—Such expenses may not be deducted by way of depreciation.[56] For comments on this point see page 907.

Patents.—A patent derives its value from the fact that it is a monopoly. The moment the monopoly ceases because of the termination of the patent term, the value is wiped out. It is true that in many cases the momentum gained during the period of legal monopoly may give a marketing advantage which is of some value for a considerable period after the expiration of the term of the patent, but this is an asset closely akin to goodwill and as such is not of a nature suited to serve as a basis for the establishment of depreciation reserves. In other words a proportionate part of cost or value March 1, 1913, of a patent should be charged off periodically so that the cost may be completely extinguished by the expiration date. Since patents in this country are issued for a term of 17 years, 17 should constitute the maximum number of annual instalments.

Life more than 17 years when application was pending March 1, 1913.—When an application for a patent was pending March 1, 1913, and the patent was issued and dated March 1, 1915, the appraised value of the patent March 1, 1913, subject to depreciation should be spread ratably over 19 years. The capital value at March 1, 1913, is the amount to be returned through depreciation charges, and it is obvious that the property which existed at that date had a remaining life of 19 years and not 17 years.

Of course, it by no means follows that a patent possesses

[56] Bulletin "F," page 12. See page 907.

value during its whole life. Revaluations should be made frequently. They often reveal the desirability of readjusting depreciation rates and of charging off sums as losses.[57] It may be that the process covered by the patent has become obsolete or that the article made is not in demand or is salable at a price too low to justify its manufacture. Again, if a patent is purchased after part of its term has expired, the rate should be based upon the unexpired term only.

A patent which has been leased and not purchased should not be treated as an asset except to the extent of its actual cost in fees, etc., unless acquired before March 1, 1913. To capitalize a patent lease purchased since March 1, 1913, at any sum in excess of cost would be as incorrect as to capitalize goodwill in excess of cost, although one or the other is a latent asset in every paying concern.

REGULATION. In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. The allowance should be computed by an apportionment of the cost of the patent or copyright or of its fair market value as of March 1, 1913, over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorney's fees, etc., actually paid. If a corporation purchased a patent and paid for it in stock or securities, its cost is the fair market value of the stock or securities at the time of the purchase. . . . . (Art. 167.)

In many cases the market value of securities indicates the fair market value of the assets purchased with such securities, but in many other cases the value of the asset and the value of the securities issued therefor vary to a considerable extent. The chief reason for the variation is that the securities issued may be part of a larger issue or sales may be made under favorable or unfavorable conditions.

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[57] See page 652.

Depreciation based on fair market value at March 1, 1913.—

Regulation. . . . . Depreciation of a patent can be taken on the basis of the fair market value as of March 1, 1913,[58] only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. . . . . (Art. 167.)

"Satisfactory" evidence is a reasonable requirement and must be met. The taxpayer is entitled to produce evidence of subsequent development and success as bearing on the probable value at March 1, 1913. The estimates of inventors and others as to values, while not conclusive, are *prima facie* evidence when it appears that such estimates were made in good faith.

The value placed upon patents by competition is difficult to ascertain but is sometimes available. The testimony of those who have valued patents, bought and sold them or participated in negotiations, is admissible.[59]

Rate to be used when patent becomes obsolete.—

Regulation. . . . . If the patent becomes obsolete prior to its expiration such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the date when it was acquired and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if affirmative and satisfactory evidence that the obsolescence occurred in the year for which the return is made is submitted to the Commissioner. . . . . (Art. 167.)

When patent right is extended.—A corporation acquired patent rights for a period of 23.5 months. Subse-

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[58] [Former Procedure] Depreciation was permitted only on the basis of actual cost thereof and not on estimated value as of March 1, 1913 (Reg. 33, 1918, Art. 174), but for some years the author has contended that the March 1, 1913, value was permitted by the law. (See *Income Tax Procedure*, 1919, pages 572-573.)

[59] For full discussion of value at March 1, 1913, see page 651.

quently a new right to extend for a period of eight years was secured. The taxpayer claimed the right to spread the depreciation over the remaining eight years, which the Treasury denied.

RULING. In the determination of the depreciation allowance which may be claimed in the 1917 return of the taxpayer, two factors must be known and are apparent in the record, to wit: the cost of the asset, and its life, as determined by the period for which the right under which the company operated in 1917, was to run.

These factors as shown by the record are: cost of asset, x dollars; and life of asset, 23.5 months.

It is the opinion of the Committee, therefore, that the depreciation allowance to which the taxpayer is entitled for the calendar year 1917 is an amount which bears the same ratio to x dollars as twelve months (the taxable year) bears to 23.5 months (the total period or life of the asset). (B. 44-21-1893; A. R. R. 520.)

PATENT LITIGATION DEDUCTIBLE AS EXPENSE.[60]—

RULING. . . . . The conclusion of the committee is that the amounts expended by the corporation in the instant case in litigation, after the patent had been secured by B and had been transferred to the corporation, constitute necessary operating expenses and should not be capitalized. . . . . (C. B. 2, page 105; A. R. R. 98.)

WHEN DEPRECIATION NOT TAKEN IN PRIOR YEARS.—

REGULATION. . . . . The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable. . . . . (Art. 167.)

The preliminary edition of art. 167, Reg. 45, provided that "a taxpayer may elect not to take a depreciation allowance but such election if made is final and will control the returns for all subsequent years." It is a fair statement that nothing is final in income tax practice, even regulations, because the sentence quoted was omitted from the April 17, 1919, edition of the regulations.

Taxpayers cannot be estopped from revising accounting procedure when it is discovered that past procedure did not properly reflect net income.

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[60] See Chapter XXVI.

A patent may be purchased for $100,000. It may have ten years to run. During the first few years after purchase development work may be going on, there may be no gross income or net income, and it may be decided that no depreciation has taken place, consequently none is charged. After several years the commercial use of the patent begins and gross income is received. It may then be decided that depreciation should be charged. Surely it could not be held that any depreciation in the earlier years had taken place.

RULING. . . . . In January, 1902, the M Company, then a newly organized corporation, acquired ownership of eight patents issuing therefor to A, the patentee, 900*x* dollars of stock of the corporation. This amount was subsequently increased 2*x* dollars by expenses of acquisition. The patents so acquired, except one, issued in 1900, had expired prior to January 1, 1917, but as of March 1, 1913, all but one were in effect. . . . . No depreciation was taken by the taxpayer on the patents which were capitalized, until the year 1917, when 1/17 of the book value was charged to expenses notwithstanding the fact that all except one of them had expired prior to January 1, 1917. . . . .

The basis for deduction authorized . . . . is the return of capital on an asset, the use of which in the trade or business is definitely limited in duration. The taxpayer did not elect, during the life of the patents acquired in 1902, to provide for this return of capital. Had he made this provision his surplus for invested capital purposes under the Revenue Act would have been correspondingly reduced.

He, therefore, can not now claim in a high taxable year, after the expiration of the life of the patents, an amount equivalent to one-seventeenth of the cost, thereby securing the benefit not only of a reduction in his taxable income for the year 1917, but the advantage of the investment, which in value is subject only to the definite limitations prescribed by the Act and the regulations. . . . . (C. B. 3, page 172; A. R. M. 95.)

It was possible, however, for the corporation to revalue any new patents acquired prior to March 1, 1913, and unexpired on that date. Depreciation on such revaluation would be allowed.

It is legitimate and legal to make changes in bookkeeping methods and take advantage of deductions under laws which impose high tax rates, irrespective of the taxpayers' former methods.

LIFE OF PATENT OR TRADE-MARK IN FOREIGN COUNTRIES.[61]—

Country	Term of Patent	Term of Trade-Mark
Great Britain	16 years. Extended from 14 years by act of Parliament, 1919	14 years renewable.
France	5, 10, or 15 years from filing of application	15 years renewable.
Germany	15 years from next day after filing	10 years renewable.
Russia	15 years	1 to 10.
Canada	18 years	General unlimited; special 25 years renewable.
Australia	14 years	14 years renewable.
Austria	15 years	10 years renewable.
Switzerland	10 years for chemical process. 15 years from filing.	20 years renewable.
Sweden	15 years from filing	10 years renewable.
Denmark	15 years	10 years renewable.
United States	17 years	20 years renewable.

Patterns, drawings, models, designs, etc.—The difficulty which the accountant encounters in the proper valuation of such patterns as are successful is to persuade proprietors to accept valuations which are reasonably conservative. Where patterns are used for stock or regular output, their value depends upon their life and upon the probability of renewed use. Where acquired or made for special jobs, the residual value is small, and the life of the patterns should be considered coextensive with the life of the jobs themselves. In every case items such as these should be looked upon with suspicion, and convincing proof must be adduced before placing any material sum on their account as an asset. An auditor often meets with strong opposition in his efforts to reduce these items to reasonable amounts, for they represent the skill and often the affections of the proprietors, who dislike to see their value depreciated on the books. But the public demand is fickle, and patterns must be made to suit the changing taste. Even what appear to be standard patterns for stable businesses often change rapidly. Engineers make almost as many alterations in their "styles" as do milliners. When the demand ceases most of the old patterns should be scrapped. This rule applies to hardware designs as well as to patterns for women's dresses.

[61] Bulletin 45-20-1293; O. D. 721.

An analysis of the sales, showing articles made from specific patterns, is evidence that the patterns have a life beyond the year in which their cost was incurred. Such an analysis is particularly useful in those cases in which repeat orders are received sometimes several years after the original sale was made. Patterns used only rarely are often scrapped and new ones made as occasion requires. In such instances the *drawing* has the value.

The charges against this account are usually cumulative, i.e., they follow the output almost automatically, thus indicating that most of the old patterns, etc., are obsolete or have been discarded. Usually depreciation charges should equal the annual expenditures for new patterns, etc. Wherever feasible, the conservative course is to write down the book value to $1.

Earlier regulations[62] have required that expenditures for successful patterns, etc., must be capitalized and specifically written off, the charge being based on their effective life. The regulations under both the 1918 and 1921 laws give to the taxpayer the option of charging off such items as expenses or of capitalizing them.

Regulation. A taxpayer who has incurred expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner. Except for such depreciation allowances no deduction shall be made by the taxpayer against any sum so set up as an asset except on the sale or other disposition of such assets at a loss or on proof of a total loss thereof. (Art. 168.)

Ruling. The cost of tracings, patterns, and flasks necessary in the business of a corporation was charged to expense from 1909

[62] Reg. 33, 1918, Arts. 175-177.

to 1912, no new equipment of that nature having been acquired subsequently. In order to restore the value of such equipment to capital account for the purpose of computing depreciation deductions, the corporation had an appraisal made in 1920, of the value as of March 1, 1913, of such equipment still in existence and use, based on the cost of reproduction of the equipment as of March 1, 1913, such cost less depreciation from original acquisition being treated as the value as of March 1, 1913. In the absence of other evidence of value, the Committee approves this method of valuation and recommends its acceptance, provided proper adjustment of the erroneous charges to expense from 1909 to 1912, be made in amended returns for those years. (C. B. 3, page 173; A. R. R. 272.)

Printing.—The depreciation of printing plants is about the same as that in the textile industry (see page 1119) with the exception of type, printers' tools, electrotypes, plates, etc., on which from 10 to 25 per cent should be applied annually. Some authorities recommend a rate as high as 25 per cent on type and electroplates.

Professions—physician's claims for depreciation.—In New York a physician made the following claims for depreciation which were allowed:

Residence, brick construction, on part occupied as offices only	5%
Automobile	20
Books	20
Instruments	25
Office furniture	20
Country residence, wood construction, on part occupied as offices only	10

Radium—no depreciation allowed.—

Ruling. Since the full life of radium has been scientifically estimated at such an extended period and since no appreciable depreciation results from its continued use as a therapeutic agent, the depreciation occurring during the lifetime of any individual owner is practically negligible. It is held, therefore, that radium which is used as a therapeutic agent is not subject to depreciation for income tax purposes and its cost must be treated as a capital expenditure. The return of capital will be realized upon its sale or other disposition. (C. B. 4, page 178; O. D. 837.)

Railroad sidings.—

Ruling. A railroad company constructed a siding to connect the property of the M Company with its railroad. A part of the siding on land of the M Company is owned by the M Company. The cost was borne by the M Company and is recoverable through depreciation allowances.

A part of the siding on land of the railroad company is owned by the railroad company. The cost was borne by the M Company and is a business expense deductible for the year in which it was incurred. (Also sec. 214 (a) 1, art. 101.) (B. Digest 36-21-1800; O. D. 1019.)

Shipping industry.—Prior to 1920 satisfactory American rates applicable to this industry were not available. The rates claimed by ship-owners were far from uniform.[63]

Bulk freight steamships—Great Lakes.—

Ruling. Three per cent is held to be a reasonable allowance for depreciation of bulk freight steamships on the Great Lakes; however, when due to peculiar conditions, it can be definitely determined that the established rate of depreciation will not be sufficient to return all of the capital invested, as at the date of acquisition or March 1, 1913, whichever is later, by the time the vessel will be rendered useless, an addition to the regular rate to cover obsolescence, may be allowed. The amount of this addition must be determined upon the basis of the facts in each particular case; that is, the type of the vessel in question, the fitness for possible use in other lines of transportation and the date when it can be definitely foreseen that she will be no longer commercially useful in this particular line of traffic.

This rule does not necessarily apply to steamers engaged in other lines of traffic, for the reason that there are distinct differences in the method of construction and the matter of operation of package freighters and passenger steamers and the bulk freighters under consideration. (C. B. 2, page 139; A. R. R. 27.)

With reference to increasing the rate on account of accruing obsolescence, the Treasury in the detailed ruling held:

. . . . obsolescence should be limited to those cases where it can be shown that a type of vessel has been developed so much more economical than existing types, that no other than the new type will be built in future, and that a sufficient number of the new type to meet traffic requirements will in all reasonable probability be built

[63] For British rates see *Income Tax Procedure*, 1920, pages 733-735.

within a certain definite period, thereby forcing the older type out of useful existence.

Some of the United States Shipping Board vessels were operated under charters which gave the charterers the option to purchase the vessels. The initial cost of re-conditioning, which was borne by the charterers, was applied on the purchase price, less depreciation at the rate of 7½ per cent per annum.

SHIPS REQUISITIONED BY SHIPPING BOARD.—

RULING. Ships in process of construction under contract were requisitioned by the Shipping Board, completed, and then reconveyed to the company from which they were requisitioned for an amount in excess of the contract price of the ships. Held, that the entire cost of the ships is a capital expenditure recoverable by allowances for depreciation, obsolescence, and amortization to the extent allowable under the Revenue Act of 1918 and Regulations 45, and that the excess of the cost over the contract price is not deductible as a loss or a business expense. (C. B. 4, page 179; O. D. 851.)

STEAM SCHOONERS.—Depreciation of steam schooners engaged in the coastwise lumber trade was fixed at 5 per cent.[64]

Soap industry.—Depreciation in this industry is about the same as in chemical factories.[65]

Textile industry.—In the textile industry the depreciation of buildings is somewhat heavy owing to the vibration of the machines. The rate assigned to the machinery is often made high because of the likelihood of obsolescence and the introduction of new appliances. The average depreciation provides for about 3 per cent on the building, if of fireproof brick construction, and 6 per cent on the machinery.

There is a wide variance in practice as to the depreciation of textile machinery. In some districts where machines, perhaps fifty years old, are giving good service today, the disposi-

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[64] Bulletin 42-20-1245; A. R. R. 279.

[65] See page 1093.

tion is toward low rates. In this industry the continual renewal of many different parts of a loom serves to reduce the depreciation rate. Experience proves, however, that some of these old machines are "pets," while more modern machines which have been worn out and replaced several times in the same period are forgotten. A writer in the *Textile World Record* suggested 3¾ per cent as a rate for cotton and woolen machinery, including spinning and weaving machinery. A large Boston firm of textile mill engineers uses these rates:

Woolen and worsted machinery	2-2½%
Cotton machinery	3
Dyeing and similar machinery subjected to acid fumes, etc	5

Timber industry.[66]—Specific provision is made in the regulations regarding depreciation of property used in a timber project when the probable life of the asset exceeds that of the project itself. The same rules as apply in the case of mining, oil and gas projects apply here, viz., that the life of the project shall be considered a limiting factor, due allowance being made for salvage value.

Ruling. A lumber company contracts to cut and saw the timber on a certain tract of land, the estimated time required being two years. It erects buildings and installs equipment which by reason of prohibitive cost of removal will be worth only the salvage value upon completion of the contract. The cost of the property and equipment may be charged off and deducted as depreciation allowances on the basis of the time required to complete the contract, or in the proportion that the amount of timber cut and sawed each year bears to the total amount of timber available. (Bulletin "F," pages 31, 32.)

Depreciation of timber plants, improvements and equipment.—

Regulations. In the case of a timber property held for future operation by an owner having no substantial income from the property or from other sources, all expenditures for administration, protection, and other carrying charges prior to production on a normal

[66] For regulations relating to depletion of timber lands, see Chapter XXXIII.

basis shall be charged to capital account; after such a property is on a normal production basis such expenditures shall be treated as current operating expenses. In case a taxpayer, who has a substantial income from other sources, owns a timber property which is not yet on a normal production basis, he may, at his option, charge such expenditures with respect to such timber property to capital, or treat them as current operating expenses, but whichever system is adopted must be followed until permission to change to the other system is secured from the Commissioner. In the case of timber operations all expenditures prior to production for plants, improvements, and equipment, and thereafter all major items of plant and equipment shall be charged to capital account for purposes of depreciation. After a timber operation has been developed and equipped and has reached its normal output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current operating expenses, ... unless the taxpayer elects to write off such expenditures through charges for depreciation; however, the method adopted must be followed consistently from year to year. (Art. 231.)

The cost or value as of March 1, 1913, as the case may be, of development not represented by physical property having an inventory value, and such cost or value of all physical property which has not been deducted and allowed as expense in the returns of the taxpayer, shall be recoverable through depreciation. It shall be optional with the taxpayer, subject to the approval of the Commissioner, (*a*) whether the cost or value, as the case may be, of the property subject to depreciation shall be recovered at a rate established by current exhaustion of stumpage, or (*b*) whether the cost or value shall be recovered by appropriate charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. In no case may charges for depreciation be based on a rate which will extinguish the cost or value of the property prior to the termination of its useful life. Nothing in these regulations shall be interpreted to mean that the value of a timber plant and equipment, so far as it is represented by physical property having an inventory value, may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation. (Art. 232.)

In the computation of depreciation it is recognized that "the reasonable expectation of the economic life" may increase

the amount of depreciation. This principle also applies to depletion charges.[67]

Tools, jigs, dies, etc.—As a rule the practice of depreciating small tools by means of a percentage cannot be followed satisfactorily. So many such tools are used up, lost or stolen, that an inventory should be made periodically and all the tools on hand should then be revalued. If this plan is followed for several years and a trustworthy rate of depreciation is secured, it may be feasible to omit the revaluation for a year or two, applying the rate previously ascertained. The tax commissioner of one of the states has adopted rates varying from 25 to 50 per cent or, as an alternative, the entire cost of replacements.

In many manufacturing concerns the item of tools, jigs, dies, etc., not standard equipment, is a large one and the tendency is to overvalue it. Heavy depreciation should be applied, because most of such equipment is made or adapted for special uses, and the inevitable changes in types and styles of production require corresponding changes in the tools. As stated heretofore under "Patterns, drawings, models, designs, etc.," (page 1114), the book value shall be written down very rapidly. The minimum rate should not be less than 20 per cent.

Edward N. Hurley, former chairman of the Federal Trade Commission, urges that special tools be charged off practically at once, and states that the neglect to depreciate this account rapidly enough has been responsible for many failures.

Typewriters.—In the average office, the life of a good typewriter, if properly cared for, is from three to five years. In some offices the machines are turned in and new ones purchased every two or three years. Such typewriters are repaired and resold and are used several years more by those who buy them second-hand. Repairs are not profitable after

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[67] See page 1231.

the machines have been used from six to eight years. An annual depreciation rate of 20 per cent is conservative.

Uniforms—naval and military.—Under the provisions of article 291 of Regulations 62,[68] the cost of an officer's uniform is not deductible from income, as it is deemed to take the place of clothing required in civilian life. It has now been decided that for the same reason depreciation cannot be claimed on uniforms.

RULING. A deduction may not be claimed to cover depreciation in the value of uniforms by an officer of the Navy. (B. Digest 32-21-1761; A. R. R. 594.)

A taxpayer claimed the same allowance as is granted in the case of theatrical costumes,[69] on the ground that uniforms should be classed as business assets. The Committee on Appeals and Reviews held, however, that since they may be worn on other than official occasions, such as weddings, receptions, etc., they are not used exclusively for "business purposes."

Wagons, trucks, etc.—In the case of wagons it will be found that 8 to 10 per cent per annum is an ample allowance, provided that all repairs, renewals of parts and maintenance are charged to operating expenses.

Wood-working industry.—On buildings and equipment in the wood-working industry the depreciation is low—about 2 or 3 per cent on buildings and 6 per cent on equipment.

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[68] See page 867.
[69] See Art. 162, quoted on page 1056.

TABLE OF DEPRECIATION RATES

For treatment of specific items of depreciable property, see preceding pages

Item	Rate Per cent	Authority	Publication
Adding machines	20	Nicholson & Rohrbach	Cost Accounting
Agricultural machinery	10	Australia Fed. Income Tax	
	6–12	Montgomery, R. H.	Auditing, Theory & Practice
Alternators	5	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	4	Bay State Rate Case	Pub. Utility Reports annotated, 1916 F
Apartment houses	3	U. S. Dist. Court (N. Y.)	Cohen v. John Z. Lowe, Jr., 234 Fed. 474
Asphalt pavements	5–6⅔	Bay State Rate Case	Pub. Utility Reports annotated, 1916 F
	8⅓–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Automobiles:			
Motor trucks	20	Piez, Chas.	Trans. A. S. M. E., 1916
	20	Belt, R. E.	Foundry Cost Accounting
	25	Associated General Contractors	Bulletin, Feb. 26, 1921
Motor cars	25–40	Dana, Richard T.	Handbook of Construction Plant
	25	Philadelphia Controller	Manual of Accounting
Ballast, railroad	3	Gillette & Dana	Mech. & Elect. Cost Data
	10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Batteries, storage	5–11	Cravens, Geo. A.	Electrical Review, 1910
	5–6⅔	Floy, Henry	Valuation of Public Utilities
	3–10	Gillette & Dana	Mech. & Elect. Cost Data
Belting	5	Wisconsin P. S. Com.	Reports
	5–12½	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	33	Kent, Wm.	Cost Accounting for Factories
	4–10	Kimball, D. S.	Cost Finding
Blowers:			
Centrifugal	6⅔	Gillette & Dana	Mech. & Elect. Cost Data
Gas plant	5–6⅔	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Boilers	6.6 to 8.5	Wisconsin P. S. Com.	Reports
	3⅓–6⅔	Am. Waterworks, Assn.	Reports
	2½–10	Gillette & Dana	Mech. & Elect. Cost Data
Bridges:			
Masonry	1	Bryan, W. H.	Eng. News, 1908
Steel	3	Bryan, W. H.	Eng. News, 1908
	4–5	Gillette & Dana	Mech. & Elect. Cost Data
Wooden	5–6⅔	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Buckets, excavating	18¾	Associated General Contractors	Bulletin, February 26, 1921

TABLE OF DEPRECIATION RATES—Continued

Item	Rate Per cent	Authority	Publication
Buildings:			
Brick	3	Fiez, Chas.	Trans. A. S. M. E., 1916
	4	Gillette & Dana	Mech. & Elect. Cost Data
	2–7	Bryan, W. H.	Eng. News, 1908
Concrete	$1\frac{1}{2}$	Wisconsin P. S. Com.	Reports
	2	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	4	U. S. Int. Revenue	Manual for the Oil & Gas Industry, 1921
Fireproof, modern	$2\frac{1}{2}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	2–4	Foster, H. A.	Eng. Valuation of Public Utilities
Frame	5	Mucklow, Walter	Real Estate Accounts
	3–6	Kimball, D. S.	Cost Finding
Cables:			
Underground (lead covered)	4–5	Wisconsin P. S. Com.	Reports
	$3\frac{1}{3}$	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
Aerial (lead covered)	$8\frac{1}{3}$	Wisconsin P. S. Com.	Reports
	$6\frac{2}{3}$–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	$6\frac{2}{3}$–$8\frac{1}{3}$	Gillette & Dana	Mech. & Elect. Cost Data
Car bodies	4–$6\frac{2}{3}$	Floy, Henry	Valuation of Public Utilities
	5–8	Gillette & Dana	Mech. & Elec. Cost Data
Car trucks	$3\frac{1}{2}$–5	Floy, Henry	Valuation of Public Utilities
	$3\frac{1}{3}$–$6\frac{2}{3}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Cars:			
Elec. and street railway	$3\frac{1}{3}$–5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	5–$8\frac{1}{2}$	Floy, Henry	Valuation of Public Utilities
Steel railroad			
Freight	2–$3\frac{1}{3}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Passenger	$2\frac{1}{2}$–3	Do.	Do.
Oil tank	5	U. S. Internal Revenue	Manual for the Oil & Gas Industry, 1921
Carts, hand drawn	20	Philadelphia Controller	Manual of Accounting
Chimneys:			
Brick	3–7	Gillette & Dana	Mech. & Elec. Cost Data
Steel	10	Do.	Do.
Compressors:			
Air	6	Piez, Chas.	Trans. A. S. M. E., 1916
	$7\frac{1}{2}$	Belt, R. E.	Foundry Cost accounting
Air brake	5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F

*For special rates of depreciation on oil and gas equipment and buildings, see *Manual*, page 62 *et seq.*

Condensers	4–5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	$3\frac{1}{3}$–10	Gillette & Dana	Mech. & Elec. Cost Data
Condensers and scrubbers (gas plant)	$3\frac{1}{3}$	Do.	Do.
Conduits:			
Cast iron	$1\frac{1}{3}$–2	Gillette & Dana	Mech. & Elec. Cost Data
Clay	2	Foster, H. A.	Eng. Valuation of Pub. Utilities
Wooden	5	Do.	Do.
	$2\frac{1}{2}$–3	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Wrought iron or steel	$3\frac{1}{3}$–5	Gillette & Dana	Mech. & Elec. Cost Data
Containers:			
Barrels, steel oil	$14\frac{2}{7}$	U. S. Int. Revenue	Manual for the Oil & Gas Industry, 1921
Cans, milk, ash, feed	$33\frac{1}{3}$	Philadelphia Controller	Manual of Accounting
Casks	10	Various	
Converters, rotary	3–$6\frac{2}{3}$	Cravens, G. A.	Elec. Review, 1910
	4–5	Gillette & Dana	Mech. & Elect. Cost Data
Conveyors, general:	$04\frac{1}{2}$	Do.	Do.
Belt or bucket	$37\frac{1}{2}$	Associated General Contractors	Bulletin, February 26, 1921
Coal or ash	10	Floy, Henry	Valuation of Public Utilities
Core ovens and apparatus:			
Steel	$7\frac{1}{2}$	Belt, R. E.	Foundry Cost Accounting
Brick	10	Do.	Do.
Core machines	15	Do.	Do.
Cranes:			
General	2	Gillette & Dana	Mech. & Elect. Cost Data
	2–$6\frac{2}{3}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Locomotive	$9\frac{1}{2}$	Associated General Contractors	Bulletin, Feb. 26, 1921
Traveling	$7\frac{1}{2}$	Belt, R. E.	Foundry Cost Accounting
	$4\frac{1}{2}$	Piez, Chas.	Trans. A. S. M. E., 1916
Cross-arms, electric light and power	10	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	$8\frac{1}{3}$–$12\frac{1}{2}$	Gillette & Dana	Mech. & Elect. Cost Data
Cupolas	5	Belt, R. E.	Foundry Cost Accounting
Crucibles	$7\frac{1}{2}$	Do.	Do.
Derricks:			
Steel	$7\frac{1}{2}$	Associated General Contractors	Bulletin, February 26, 1921
Wooden	15	Do.	Do.
Dies	25–50	Wood, C. E.	Accounting Methods for Industrials
Drills:			
Presses	5–$7\frac{1}{2}$	Am. Foundrymen's Assn.	Standard Foundry Costs
Tripod or jackhammer	$18\frac{3}{4}$	Associated General Contractors	Bulletin, February 26, 1921
Drivers, steam pile	$9\frac{1}{2}$	Do.	Do.
Dry dock, floating	5	Atl. Coast Shipbuilders' Assn.	Cost Accounting Manual
Dwellings:			
Brick	$1\frac{1}{2}$–$2\frac{1}{2}$	Tiffany, H. S.	Digest of Depreciation
Frame	$2\frac{1}{2}$–$4\frac{1}{2}$	Do.	Do.
	3	Gillette & Dana	Mech. & Elect. Cost Data

TABLE OF DEPRECIATION RATES—Continued

Item	Rate Per cent	Authority	Publication
Dynamos (See "Generators")			
Elevators, grain	3	Do.	Do.
Engines:			
Gas	5	Belt, R. E.	Foundry Cost Accounting
	6⅔–10	Kimball, Dexter S.	Cost Finding
	6⅔	Gillette & Dana	Mech. & Elect. Cost Data
Steam	5–10	Do.	Do.
	5	Belt, R. E.	Foundry Cost Accounting
	4–6.6	Cravens, G. A.	Elec. Review, 1910
Fences:			
Wire	7½	Belt, R. E.	Foundry Cost Accounting
Wooden	10	Do.	Do.
Fire extinguishers	10	Philadelphia Controller	Manual of Accounting
Fire protection apparatus	8⅓	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Fixtures, office	10	Belt, R. E.	Foundry Cost Accounting
Foundries:			
Furnaces, air	7½	Belt, R. E.	Foundry Cost Accounting
Flasks, iron, steel or aluminum	10–33⅓	Am. Foundrymen's Assn.	Standard Foundry Costs
	50	Piez, Chas.	Trans. A. S. M. E., 1916
Furnaces:			
Blast	5	H. S. Tiffany	Digest of Depreciation
Electric or open hearth	10	Belt, R. E.	Foundry Cost Accounting
Furniture and fixtures	10–20	Kester, R. B.	Accounting Theory and Practice, Vol. II
	5–8	Gillette & Dana	Mech. & Elect. Cost Data
Generators	3⅓–8	Do.	Do.
	5–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	4–8.3	Cravens, G. A.	Elec. Review, 1910
	7½	Belt, R. E.	Foundry Cost Accounting
Hammers:			
Drop	10	Do.	Do.
	4½	Piez, Chas.	Trans. A. S. M. E., 1916
Pneumatic	15	Clapham, F. T.	Mechanical World, 1917
Steam	10	Nicholson & Rohrbach	Cost Accounting
Harness	12½	Philadelphia Controller	Manual of Accounting
Heating and ventilating system	5	Piez, Chas.	Trans. A. S. M. E., 1916
Heating systems—steam	5	Belt, R. E.	Foundry Cost Accounting
Hoists, various	7½–12½	Various	Accountants Index

Horses	5–20	Gillette & Dana	Mech. & Elect. Cost Data
	10	Philadelphia Controller	Manual of Accounting
Hydrants	2–3	Metcalf, Leonard	Trans. A. S. M. E., 1916
Laboratory equipment	10	Belt, R. E.	Foundry Cost Accounting
Lathes, steel	10	Do.	Do.
Laundry equipment	8⅓	Philadelphia Controller	Manual of Accounting
Locomotives, steam or electric	6⅔	Nicholson & Rohrbach	Cost Accounting
Machinery, general'	7½–10	Woods, C. E.	Accounting Methods for Industrials
	5–10	Belt, R. E.	Foundry Cost Accounting
	4	Grunsky, C. E.	Valuation Deprec. & Rate Base
	12½	Gillette & Dana	Mech. & Elect. Cost Data
Meters:			
Electric	5	Am. Foundrymen's Assn.	Standard Foundry Costs
	6⅔–8	Gillette & Dana	Mech. & Elect. Cost Data
Gas	4	Do.	Do.
Oil	7½	Am. Foundrymen's Assn.	Standard Foundry Costs
Steam floor	10	Do.	Do.
Water	5	Gillette & Dana	Mech. & Elect. Cost Data
Milling machines	10	Belt, R. E.	Foundry Cost Accounting
Motors, electric	5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	12½	Associated General Contractors	Bulletin, February 26, 1921
	4–8.3	Cravens, G. A.	Elect. Review, 1910
Oil separators	7½	Belt, R. E.	Factory Cost Accounting
Patterns	75–100	Piez, Chas.	Trans. A. S. M. E., 1916
	20–33⅓	McIntosh, Robt.	Reference Book of Accounting (2nd Ed.)
Pavements:			
Asphalt	7	Foster, H. A.	Eng. Valuation of Public Utilities
Brick	4½	Gillette & Dana	Mech. & Elect. Cost Data
Granite	4⅘–6¼	Grunsky, C. E.	Valuation Deprec. & Rate Base
Macadam	5½–12½	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
Wood block	3⅓–5	Do.	Do.
Piping	4	Do.	Do.
	4–8.3	Cravens, G. A.	Elect. Review, 1910
	10	Kent, William	Cost Accounting for Factories
Plumbing	3⅓–4	Philadelphia Controller	Manual of Accounting
Poles:			
Iron or steel set in concrete	3⅓–6⅔	Foster, H. A.	Eng. Valuation of Public Utilities
Wood	5½–10	Do.	Do.
Presses:			
Drill	10	Belt, R. E.	Foundry Cost Accounting
Punch	4½	Piez, Chas.	Trans. A. S. M. E., 1916
Pumps	5–8⅓	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
	5	Belt, R. E.	Foundry Cost Accounting
Power plant equipment	7½	Do.	Do.
Rails	8	Gillette & Dana	Mech. & Elect. Cost Data
	3⅓–10	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
	4–6⅔	Grunsky, C. E.	Valuation Deprec. & Rate Base

TABLE OF DEPRECIATION RATES—CONTINUED

Item	Rate Per cent	Authority	Publication
Refinery, equipment:			
Distillation	15	Dept. of Int. Revenue	Manual for Oil & Gas Industry, 1921
Pipes and fittings	12	Do.	Do.
Power plant	10	Do.	Do.
Lubricating plant	10	Do.	Do.
Miscellaneous	10	Do.	Do.
Storage	8	Do.	Do.
Rolling stock—railroad	5–7	Foster, H. A.	Eng. Valuation of Public Utilities
	5–$8\frac{1}{2}$	Chicago Union Traction Co.	Chicago Traction Com. Report
Sand mixers	15	Belt, R. E.	Foundry Cost Accounting
Sand blast barrels and tables	25	Do.	Do.
Saw rigs	$18\frac{3}{4}$	Associated General Contractors	Bulletin, February 26, 1921.
Sewers	$2\frac{1}{2}$	Belt, R. E.	Foundry Cost Accounting
Shafting, pulleys, etc.	4	Philadelphia Controller	Manual of Accounting
	$4\frac{3}{4}$	Kimball, Dexter S.	Cost Finding
Ships:			
Steel or iron (ocean going)	3	Gillette & Dana	Mech. & Elect. Cost Data
Steel or iron (inland water)	$2\frac{1}{2}$	Do.	Do.
Shop, equipment	5–15	Cravens, G. A.	Elect. Review, 1910
Sprinkler system	3–$7\frac{1}{2}$	Am. Foundrymen's Assn.	Standard Foundry Costs
	5	Belt, R. E.	Foundry Cost Accounting
Stacks:			
Bricks	5	Do.	Do.
	3	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Steel	4–10	Am. Waterworks Assn.	Reports
	10	Gillette & Dana	Mech. & Elect. Cost Data
Steam power plants	5	Do.	Do.
Switch boards	$8\frac{1}{3}$	Philadelphia Controller	Manual of Accounting
Telephone	10–$12\frac{1}{2}$	Foster, H. A.	Eng. Valuation of Public Utilities
	$8\frac{1}{3}$–$12\frac{1}{2}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Electric companies	$4\frac{1}{2}$	Foster, H. A.	Eng. Valuation of Public Utilities
	2–$6\frac{2}{3}$	Gillette & Dana	Mech. & Elect. Cost Data
Switchboard and instruments	2–8.3	Cravens, G. A.	Elect. Review, 1910.
Tanks:			
Steel	$6\frac{2}{3}$	Gillette & Dana	Mech. & Elect. Cost Data
	$4\frac{1}{2}$	Piez, Chas.	Trans. A. S. M. E., 1916
Wooden	10	Do.	Do.
	$8\frac{1}{3}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Testing machines, tensile	5	Belt, R. E.	Foundry Cost Accounting

Tools:			
Loose	10	Floy, Henry	Valuation of Public Utilities
	50	Piez, Chas.	Trans. A. S. M. E., 1916
Machine	5	Foster, H. A.	Eng. Valuation of Public Utilities
Tractors:			
Caterpillar	15	Associated General Contractors	Bulletin, February 26, 1921
Electric, industrial	25	Belt, R. E.	Foundry Cost Accounting
	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Transformers	$4\frac{1}{2}$	Foster, H. A.	Eng. Valuation of Public Utilities
	$6\frac{2}{3}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Turbines:			
Steam	3–5	Cravens, G. A.	Elect. Review, 1910
	$2\frac{1}{2}$–5	Gillette & Dana	Mech. & Elect. Cost Data
	$3\frac{1}{3}$–$6\frac{2}{3}$	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Water	2–$3\frac{1}{3}$	Do.	Do.
	$3\frac{1}{3}$	Gillette & Dana	Mech. & Elect. Cost Data
Type	25	United Typothetae	
	$33\frac{1}{3}$	R. S. Denham	Manual of Cost Eng. & Estimating
	10	Various English Authorities	
Typewriters	20	Nicholson & Rohrbach	Cost Accounting
Valves	6	Gillette & Dana	Mech. & Elect. Cost Data
	4	Philadelphia Controller	Manual of Accounting
	5–10	Am. Foundrymen's Assn.	Standard Foundry Costs
Ventilating systems	5	Piez, Chas.	Trans. A. S. M. E., 1916
Wagons:			
Dump and hauling	$18\frac{3}{4}$	Associated General Contractors	Bulletin, February 26, 1921
Horse drawn	5	Philadelphia Controller	Manual of Accounting
Warehouses, steel and tile	2	Do.	Do.
Wells:			
Driven or drilled	$1\frac{1}{3}$–2	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Gas	10	Do.	Do.
Wharves	3	Gillette & Dana	Mech. & Elect. Cost Data
	2	Philadelphia Controller	Manual of Accounting
Wiring:			
Electric	$7\frac{1}{2}$	Belt, R. E.	Foundry Cost Accounting
Switchboard	6	Piez, Chas.	Trans. A. S. M. E., 1916
Wires, telephone (copper)	5	Foster, H. A.	Eng. Valuation of Public Utilities
	5–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base

CHAPTER XXXII

DEDUCTIONS FOR EXTRAORDINARY OBSOLESCENCE AND AMORTIZATION

The 1921 law re-enacts the provisions of the 1918 law with respect to deductions for obsolescence and amortization, with certain changes imposing a limitation on the filing of amortization claims after 1921, and fixing a definite date, March 3, 1924, before which amortization allowances must be determined.[1]

Ordinary obsolescence is usually merged with depreciation and is discussed in the preceding chapter. In this chapter extraordinary obsolescence and amortization will be considered.

Obsolescence

LAW. Section 214. **(a) That in computing net income there shall be allowed as deductions: . . . .**

(8) **A reasonable allowance for . . . . obsolescence;**[2]

The Treasury prior to 1918 allowed as deductions realized obsolescence. As such deductions could have been made as losses, whether or not obsolescence as such was specified in the law, the reason for the specific mention of obsolescence in the 1918 law was to permit the accrual of obsolescence "so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art."[3]

Under the most recent rulings so-called "ordinary obsolescence," viz., that obsolescence which is accruing but which

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[1] See page 1150.

[2] This section deals with individuals. Section 234 (a-7) applies the same language to corporations.

[3] Art. 166.

cannot be definitely ascertained, is to be included in the annual depreciation allowances rather than in a specific reserve for obsolescence.

Federal income tax laws prior to 1918 contained no reference to obsolescence and amortization but conditions in 1918 required that explicit authority should be given to the Treasury to grant, and to taxpayers to deduct, adequate allowances for losses which might not otherwise be permitted.

The sudden end of the World War in 1918 is responsible for many problems which have not yet been solved. All taxpayers who increased their plant facilities prior to November, 1918, whether or not for strictly war purposes, must make an early decision regarding the effect of post-war conditions.

Facilities of any kind "for the production of articles contributing to the prosecution of the present war" if acquired or constructed after April 6, 1917, are the subject of a special deduction, but taxpayers whose facilities do not come within the technical meaning of section 234 (a-8) nevertheless are entitled [under section 234 (a-7)] to "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

The author believes that sufficient consideration has not been given to the extraordinary cost of facilities acquired after 1915, the extraordinary wear and tear of all facilities during 1917 and 1918, and the extraordinary diminution in value of such facilities as compared with post-war conditions. When claims for amortization allowances under section 234 (a-8) are rejected on technicalities, it may be found that equivalent deductions may be made under section 234 (a-7).

REGULATION. A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. . . . . (Art. 161.)

Obsolescence as described above has been discussed in the preceding chapter. Obsolescence which may be said to be "realized" is considered in the following pages.

The foregoing regulation accords with proper accounting methods. Depreciation allowances set up by conservative concerns were always supposed to be sufficient to include adequate provision for ordinary obsolescence. It follows that in fact deductions were made for obsolescence. The law now definitely sanctions the deductions which taxpayers have been making and the Treasury has been allowing for some years.

Treasury Procedure as to Obsolescence

Under previous laws the Treasury allowed as deductions reserves for depreciation, but did not allow reserves specifically for obsolescence.

Reserves for obsolescence which appeared on taxpayers' books at the beginning of the taxable year ending in 1918 were not allowable as deductions under earlier income tax laws. In order to avoid great annoyance and possible complications in the future it would be proper in most cases to transfer obsolescence reserves as of January 1, 1918, to surplus account. Commencing with that date, obsolescence reserves should reflect allowances claimed and allowed for income tax purposes.

Duplicate deductions must be avoided.—No well-regulated concern would charge off the same item of plant or equipment more than once, but on this point the law contains a special warning. Care must be taken that any allowances for depreciation or obsolescence or amortizations claimed *and allowed* in returns for years prior to the taxable year be not claimed again.[4] This, however, does not apply to amounts claimed in previous years but not allowed.

[4] Law, section 215 (a-3).

Present Accounting Practice as to Obsolescence[5]

The author believes the position assumed by the Treasury in regard to obsolescence prior to the enactment of the 1918 law was essentially sound. He is not prepared to support the contention of certain accountants that extraordinary obsolescence, like depreciation, is an item of prime cost.

To the extent that an allowance for ordinary obsolescence has been merged with depreciation it is entirely proper to charge the combined allowance to operating expenses. The attempt to anticipate extraordinary obsolescence should be from profits and not from current income.

Uncertainty of obsolescence.—Ordinary depreciation is certain and cannot be avoided any more than death or taxes. It accrues from day to day. One can see it. Obsolescence when applied to the future (there is no difference of opinion as to the treatment of known obsolescence) is a matter which is more difficult of estimate than depreciation. No one knows when it will come. In some cases, where expected, it has not materialized. In many instances, where not expected, it has come almost at once. It is true that it has occurred in the past on a great scale. Most modern machinery has superseded other machinery which was not worn out, and many a plant, only ten years old, that counted on a twenty-year life for its equipment, for which a depreciation reserve was set up on that basis, has not been able to renew the machinery out of the reserve. It is also true that in view of the rapid strides in all the mechanical sciences, obsolescence is likely to continue indefinitely to be a serious factor in the ultimate cost of producing manufactured goods. Unevenness of practice should be avoided. One man should not be permitted to guess that his machinery, having an estimated effective life, under normal conditions, of ten years, will become obsolete and have to be replaced within two years. Nor should another, owning the

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[5] See *Auditing, Theory and Practice* (3rd edition), by R. H. Montgomery, page 329.

same kind of machinery, be permitted to make his guess four years. The makers of the machinery might testify that it would perform full service for ten years. When claims for obsolescence are reasonable they should and will be allowed. When unreasonable the claimant deserves to be penalized.

Conflict of opinion as to proper practice.—Some accountants flatly contend that it is practicable and desirable to provide for all obsolescence allowances as operating expense. Others, impressed by the fact that obsolescence frequently represents a large item of cost or expense, while not wishing to include it as a direct operating expense, desire to provide for this charge at a point in the accounts before an operating or net profit is shown. Against this it is argued that if obsolescence cannot be reduced to enough of a certainty to make a periodical allowance for it, there is a strong reason for omitting it as an element of prime cost. If it can be estimated closely enough to set aside a definite amount, the author thinks it should be called depreciation rather than obsolescence. If a close estimate cannot be made the allowance should go in the accounts as an extraordinary expense, rather than as an ordinary operating expense.

Extraordinary Obsolescence

The foregoing relates to so-called "ordinary obsolescence." The regulation as to extraordinary obsolescence is as follows:

Regulation. When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the cost, or, if acquired prior to March 1, 1913, fair market price or value as of that date of any assets so discarded (less any depreciation sustained and allowable as a deduction in computing net income) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property

has been prematurely discarded, as, for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income. . . . . (Art. 143.)

The author believes that the foregoing requirement to use as a basis for obsolescence the cost of property acquired since March 1, 1913, is in accord with the law.

When the property was acquired before March 1, 1913, the deduction for obsolescence, as shown in article 143, is based on cost or value at March 1, 1913, "whichever is lower"—"less any depreciation sustained." Assume that equipment costing $40,000 having an estimated life of twenty years was acquired in 1905. Its value at March 1, 1913, is $30,000 and it is scrapped at the end of 1921. The March 1, 1913, value is held by the Treasury not to be the proper basis to use for determining the amount of obsolescence deductible because, after deducting depreciation to March 1, 1913, cost is lower than actual value at that date.

Depreciation sustained at date of sale or discard based on original cost is $34,000 (seventeen years at $2,000 per year) and depreciated cost therefore is $6,000 in 1921. Depreciation to 1921 based on March 1, 1913, value is approximately $22,-500 (nine years at $2,500 per year). The March 1, 1913, value is therefore reduced by depreciation to $7,500.[6]

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[6] For illustration of effect of depreciation on cost and March 1, 1913, values, see page 573.

[Former Procedure] In 1917 the deduction for obsolescence realized was based on cost, less depreciation and salvage. (Reg. 33, Arts. 178-179.)

The regulations issued under the 1918 law based the deduction on cost, or value at March 1, 1913, in case of property acquired prior thereto, "less any depreciation allowances" and salvage value. (Reg. 45, Art. 143.)

If sold for \$1,000, the amount to be charged off is \$5,000, provided article 143 and section 202 (b-2) of the law are applicable. But 202 (b-2) is a general provision of the law and does not control any specific provision. Actual value at March 1, 1913, is the proper basis for obsolescence under section 214 (a-8), therefore if actual value at March 1, 1913, is \$30,000, and \$22,500 has been charged off since, the deduction under section 214 (a-8) clearly is \$6,500, not \$5,000. The principle is not changed because the machine is sold instead of being discarded.

If discarded the deduction undoubtedly is \$7,500. It would be ridiculous to hold that by selling a machine for \$1,000 the deduction for obsolescence is reduced from \$6,500 to \$5,000. In years of high tax rates it would put a premium on junking good machinery. It would be a violation of every known business and economic theory of efficiency.

The Treasury in article 143 attempts to relate section 202 (b), which governs the taxable status of the sale of property in general, to a section of the law which has no reference to general gains or losses. Even if there is a relation, the specific provisions of section 214 (a-8) must control. Under the latter section value at March 1, 1913, is the value to be recovered through depreciation and obsolescence. If not recovered in one year it may be in another year. If depreciable property is sold, any value at March 1, 1913, which has not been recovered may be charged off in the year of final disposition, not as a loss but as final depreciation or obsolescence. The sale or discarding of a machine is the final test of these allowances. If the calculations were accurate there would be no question of loss or gain; if inaccurate the balance is not a gain or a loss, it is a correction of the inaccuracies. The law does not require taxpayers to go back and adjust the accounts of all prior years, but permits a reasonable adjustment in the year of determination.

The theory of a limitation on losses as contained in section 202 (b) is that taxpayers whose property had appreci-

ated in value at March 1, 1913, shall not receive the benefit of losses which represent, in effect, nothing more than failure to realize something which as appreciation formed part of their capital at March 1, 1913, but which subsequently depreciates in value. The section applies to property such as stocks and bonds which fluctuate in value; it does not apply to depreciable property which is the subject of depreciation and obsolescence allowances specifically permitted.[7]

Obsolescence accrued prior to taxable year not deductible.—

RULING. . . . . A number of 5,000-ton bulk freighters were constructed in 1900. In 1910 the docks in the larger harbors along the Great Lakes were greatly enlarged and improved so that only vessels of 10,000 tons capacity or larger could be conveniently or economically accommodated. As a result of this condition the larger and newer type of vessels could carry freight at a cheaper rate than the 5,000-ton vessels, and began at that time to dominate the lake trade and displace the smaller types. The physical life of the 5,000-ton vessels is generally conceded to be 33 years. However, for the reasons above stated, they have all been abandoned or will be abandoned by the close of the year 1921. Their salvage value is estimated at 20 per cent. In the past depreciation has been allowed at the rate of 3 per cent, in accordance with A. R. R. 27 (C. B. 2, p. 139.) The owners now claim that 20 per cent of the cost of the vessels remains on their books as a loss by reason of obsolescence and seek to deduct this 20 per cent loss during the years 1918, 1919, 1920, and 1921. . . . .

. . . . This office has consistently ruled that items of income received or accrued during any given taxable year must be returned for that year, and that losses incurred in one taxable year can not be deducted from the income of other taxable years. It has been held that the failure to take depreciation in any taxable year does not entitle the taxpayer to deduct in any other taxable year a greater amount for depreciation than would otherwise be allowed (Art. 167, Reg. 45). Article 166 of Regulations 45 provides: "Inasmuch as under the provisions of the income tax Acts in effect prior to Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to

[7] See Sections 214 (a-8) and 234 (a-7).

allow for such future obsolescence as may be expected from experience to result from the normal progress of the art." It will be noted that this article provides only for *future* obsolescence.

There appears to be nothing, therefore, in the Act or in the regulations which indicates that it was intended that obsolescence which accrued in taxable years prior to 1918 could be accumulated and deducted from gross income in years subsequent to that date; or that Congress had any intention that this particular provision should be given a retroactive effect beyond January 1, 1918.

The contention of the taxpayer is directly opposed to this well-established construction of the Act and ought not, in the judgment of this office, to be conceded. . . . .

. . . . . The facts, as indicated by the affidavits of the taxpayer, show that obsolescence began in 1910, when the larger vessels began to displace the 5,000-ton freighters. Any loss due to obsolescence should, therefore, be spread over the period from 1910 to the date of abandonment (L. O. 862; C. B. 1, p. 127), and it follows from what has been said above that only that portion of such obsolescence which accrued subsequent to January 1, 1918, can be taken in returns for 1918 and subsequent years.

Any further loss not taken care of by depreciation and obsolescence and not compensated for by insurance or otherwise may be taken in the year in which the vessels are sold or scrapped.

It is concluded that obsolescence which accrued prior to January 1, 1918, may not be deducted in income and excess-profits tax returns for 1918 and subsequent taxable years. (B. 31-21-1752; Sol. Op. 114.)

The foregoing seems to mean that obsolescence accruing from 1910 to 1917 inclusive is not a deduction in those years, nor may it be taken in the year when the vessels are disposed of, under the theory that in the year of disposal the only allowable deduction in that year is for the obsolescence which accrues in the same year. Also see article 166; page 1081.

The author wholly disagrees with the statement of the Solicitor that Congress intended that the allowance for obsolescence in the 1918 law is a limitation of the deduction. Stated otherwise, the Solicitor contends that deductions for realized obsolescence theretofore allowed by the Treasury under laws which did not mention obsolescence were outlawed by the 1918 law.

Vessels were constructed in 1900 costing $1,000,000 with

an estimated life of thirty-three years. From 1900 to 1917 depreciation accrued was allowed on a basis of the estimated life of the vessels. In 1921 the vessels were sold for $200,000. In 1918 it was known that the vessels would be obsolete in 1921. The opinion allows obsolescence for the years 1918 to 1921 inclusive on the basis of obsolescence spread over the period 1910 to 1921, which leaves a considerable book value after the sale. The opinion states that the book balance which represents the excess of obsolescence above depreciation for the years 1910 to 1917 may not be written off as obsolescence in 1921, but fails to state whether or not it may be charged off in 1921 as a loss. The reference to each year's accounts being complete in itself indicates that the only loss which arises in the year 1921 is the year's share of the obsolescence.

Under the opinion the net effect of the 1918 law is to decrease the allowable deduction for losses arising from obsolescence. No such meaning can be read into the law nor into the intention of Congress. The allowance for obsolescence was inserted in the 1918 law in conference. As with other sections of the 1918 law, the intention of Congress was to extend and amplify deductions. It is absurd to construe the obsolescence allowance as a foreclosure of a right to claim obsolescence, yet that is precisely what the Solicitor's opinion holds.

When business is discontinued.—

RULING. The undepreciated cost of a dam constructed for the purpose of creating an ice lake by a corporation which later discontinued the ice business, the dam showing a substantial salvage value remaining, was charged off the taxpayer's books. The taxpayer contended that this was a "loss of useful value" as contemplated by article 143 of Regulations 45.

The Committee is of the opinion that property so improved can not, as a matter of fact, be valueless, and that there is no evidence establishing a real determinable and determined loss within the meaning of article 143. (C. B. 4, page 165; A. R. R. 498.)

Since the business was discontinued, it is difficult to believe that no obsolescence occurred in an asset that apparently

was valueless for any other type of business. The taxpayer, however, must have failed to show that there was an actual loss in value.

Buildings.—

RULING. No amount may be charged off in any year in anticipation of obsolescence of a building which *may* become obsolete five or ten years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. The figure representing obsolescence should be, approximately, the difference between the fair market value of the building as of March 1, 1913, or its cost if acquired after that date, less depreciation, and the estimated salvage value. This obsolescence should be spread over the period from the time such obsolescence becomes certain until the building becomes obsolete and should be claimed in the returns filed for those years. For instance, the fair market value of a building March 1, 1913, was $30,000. Its depreciated value December 31, 1918, was represented by $18,000, and its estimated salvage value will be $5,000 in 1920. At that time (Dec. 31, 1918) it was definitely determined and certain that in 1920 the building would have to be torn down and rebuilt, due to its inadequacy to meet the growing needs of the industry it housed. The difference between the depreciated value December 31, 1918, namely, $18,000, and its estimated salvage value of $5,000 represents obsolescence. This amount of $13,000 should be spread over the years covering the period 1919 and 1920, and deductions claimed accordingly on the returns filed for those years. In cases where obsolescence is claimed it must be supported by facts which will enable this office to determine whether such claim is proper and allowable. (C. B. 2, page 138; O. D. 381.)

Some of the factors contributing to the obsolescence of buildings are:

1. Changing trade centers.
2. Change of fashion or design.
3. Improved methods of planning, construction and operation.
4. Better lighting and ventilating.
5. Appreciation of land values demanding greater interest return.

An eminent real estate authority has stated:[8]

The change, to a marked extent, from the old, simple types of buildings to the modern complex form, may be said to have taken place about 25 or possibly 30 years ago and it was probably not for another 10 years that all interested in real estate, in mortgages and in construction, realized fully that a new problem, that of the loss of value in great buildings through changing hotel and trade centers, through wear and tear, through change of fashion in design, improvements in method of construction and operation, of planning and designing, was a great, a serious problem.

Apartment houses.—

. . . . It was first discovered in large apartment houses that tenants generally deserted an apartment as being *obsolete* within 8 or 10 years. Hotels became old in 12 or 15 years, due to better and finer buildings being constructed. . . . . As apartment house planning and building progressed to a point where it was no longer possible to improve in planning and in appointments and in fireproof construction and especially when over-production ceased, the fashion of deserting the so-called old apartments changed, and it is now conceded that a well kept and well managed apartment house may hold its own with the new houses as they are built and maintain their earning power for 20 or 30 years instead of 8 or 10.

There is an apartment house in New York City now being constructed that has begun to depreciate before it is born. It will always be a liability as the planning and waste of money on four interior tower stairways, needless hallways and extravagant construction at a time of high building costs dooms it to a heavy depreciation in value and usefulness through inability to compete with well planned, carefully built structures of the same class. This building should have an allowance for depreciation of 5%.

Fireproof buildings.—

At first it was generally believed that a fireproof building was good for 100 years and depreciation was hardly thought of. It soon became evident that with the vast investment for elevators and machinery, for plumbing and fine appointments, and with the changing demands and types of architecture, there was a probability that the new would be *obsolete* in a comparatively short time. How short a time no one knew, but it was evident from the rapid passing of the new apartment houses into a condition of *obsolescence* that depreciation was the most serious question involved in this new form of building.

[8] Extracts from paper on "Depreciation" by Frank Lord, Vice-president Cross & Brown Co., New York City.

Loft buildings.—

Take for illustration an ordinary old type of 5 story loft building. The average building of this type with its rope hoistway and a single set of plumbing on each floor was uniformly built between 1840 and 1890 for about $30,000, sometimes for $25,000, in a flimsy way, and sometimes for $35,000 in a superior way, many of them with stout walls and yellow pine beams. Such a building might depreciate in the first ten years of its existence from its first cost of $30,000 to a value of $25,000 or an average of 1½% per annum, thereafter it would depreciate possibly 1% per annum and at the end of 20 years would be worth $20,000. Another 10 years might reduce it to a value of $18,000, but the probabilities are that it would remain steadily worth $20,000 after its first 20 years of existence, owing to substantial upkeep.

The reason for this stability lies in its measuring up in style to the prevailing standard of architecture of its day and the fact that the unchanging demands of business kept it from becoming *obsolete*. Its simplicity of construction, its honest, enduring qualities, kept it fairly on a par with its competitors and gave it equal rank with the newer buildings for rental income.

With a little outlay they could be restored to their old time respectability and be made as serviceable as in their prime. As a matter of fact these old buildings have a value today of $25,000 to $35,000 and are earning so well for their owners that they are content to take their revenues of 6% to 10% and never think of the gradual destruction they are bringing upon themselves by forcing the larger and more progressive merchants to seek modern facilities in districts uptown where such buildings are the rule rather than the exception.

Effect of appreciation in land values.—

When the 20 story Gillander building, 25 x 100, at the northwest corner of Wall and Nassau Streets was only 10 years old it was torn down to make way for the Bankers' Trust Building. It had become *obsolete* because the land could earn much more if given a higher class of building.

In 1885 old buildings at the southwest corner of Wall and Broad Streets were torn down for the erection of the Wilkes Building, which in 1920 was demolished to permit the new 24 story Stock Exchange to take its place. Here was a fine building fully able to do good work for another 20 years cut off at the age of 35 years not for any real decay and disability but because it could earn only 30% of what a higher building, extending to less prominent and valuable land adjoining can earn.

If, for example, a certain 5-story building is paying 9% net on

$80,000 and by demolishing the building and erecting a 12 story structure at a cost of $135,000 plus $80,000 for the land, the new building will pay only 7% net on $215,000, the old building paying 9% has not depreciated but is in a state of efficiency and should be maintained in this form so long as no better return could be obtained from a new building.

Change from retail to wholesale district.—

Depreciation is not necessarily a slow process which may be covered by an allowance of 3 or 5%. There may be 50 or 100% depreciation in a single year, as when 23rd Street changed from a retail to a wholesale district and buildings 25 x 100 each, capable of earning, say $30,000 a year, became unrentable and a liability, so that one owner of a building covering 7 lots demolished it to save taxes. Only a year or so before this building had a value of $200,000 to $250,000 (as a retail building) which depreciated entirely not through wearing out so much as through unfitness and inability to produce revenue.

In the largest cities the enactment of "zoning" laws is serving to give relief in those cases where in the past a sudden change might be wrought as in the last instance cited above, and must be considered in any estimate of probable obsolescence.

Fixtures.—In some types of business, such as retail candy stores, restaurants, etc., the volume of business achieved is, to an important extent, dependent upon the character and appearance of the equipment and the attractiveness of the furniture and fixtures with which the visitor finds himself surrounded. The demand of the public for elaborateness and lavish display in this regard is a constant and potent factor; and competition in that direction imposes the necessity of pleasing the public, as otherwise there would be an immediate and pronounced decline in patronage. In respect of fixtures of this nature, the ordinary depreciation rates would not adequately represent the loss of useful value accruing, and a very material allowance should each year be made for obsolescence.

CHANGE UNDER RELEASING OR UPON MOVING.—

RULING. A taxpayer in rearranging his business property in accordance with a lease, permanently abandoned certain office furniture and fixtures, only a portion of the cost of which had been deducted as depreciation. The portion of the cost not so deducted, less salvage value of the property, is deductible as a loss of useful value under article 143 of Regulations 45. (C. B. 4, page 164; A. R. R. 469.)

Obsolescence of intangible property.—

RULING. Obsolescence is not ordinarily applicable in the case of intangibles but will be allowed in exceptional cases, as in the case of the discontinuance of a going business because of the exhaustion of its source of supply, where the cost of the good will, or its value as of March 1, 1913, if acquired prior to that date, can be definitelv shown and the period of its obsolescence determined with reasonable accuracy.

To sustain a claim for deduction for obsolescence of good will it must be shown that the good will will be of no value at the close of an approximately definite period, and that the taxpayer will be forced to discontinue the business and be unable to continue in any similar business.

An allowance for obsolescence of good will will be made only in connection with such good will as is assignable, as distinguished from good will attaching to individuals owning or conducting a business, or to the premises at which it is or was conducted; and no allowance for obsolescence will be granted in any case where, in connection with the operation of the business, the good will will be valuable in another business after the termination of the business in which the taxpayer is engaged.

A corporation engaged in the business of sampling ores is entitled to a deduction for obsolescence not only of its plant and equipment but for value of good will existing and having a definitely established value as of March 1, 1913, or acquired thereafter by capital outlay, if it can be shown that the plant and equipment will be useless and the good will of no value at the close of an approximately definite period by reason of exhaustion of the ores on which its business depends. (C. B. 2, page 141; O. D. 472.)

Extraordinary obsolescence due to prohibition.—As stated in the regulation already quoted (article 143),[9] an exception to the rule "requiring a sale or other disposition of property in

[9] See page 1134.

order to establish a loss" is made "where new legislation directly or indirectly makes the continued profitable use of the property impossible."

A concrete illustration of loss occasioned by new legislation is that caused by state and national prohibition. When the slavery question was a live issue there were many who thought that slave owners, who had vested property interests in slaves, should not be deprived of their property without compensation. Likewise there are many who think that those who had acquired property rights in the liquor business should not be subjected to loss without compensation.

As with the slavery question, public sentiment is opposed to governmental compensation for losses sustained by the liquor interests, but when property losses due to prohibition are established those sustaining the losses are entitled to deductions therefor in their income and excess profits tax returns.[10]

PROPERTY USED IN THE MANUFACTURE OF ARTICLES AFFECTED BY PROHIBITION.—

RULING. Property consisting of a plant, including equipment for the manufacture of beer bottles, which because of restrictions and regulations by the United States government on the brewery industry can not be sold and in consequence the factory had to be closed, has to the extent the property or plant was constructed for the manufacture of beer bottles and is not suited or adapted for any other purpose without reconstruction, become obsolete. The corporation to that extent is entitled to a deduction for obsolescence. So much of the shrinkage in value of the plant, if any, as is not thus due to obsolescence can not be claimed as a deduction for loss until the property is sold or becomes worthless and the loss is definitely ascertained. (C. B. 1, page 133; O. D. 125.)

PROPERTY USED IN A "RELATED" BUSINESS.—

RULING. In order that a taxpayer may be allowed a deduction for obsolescence for any given period, it is essential that the use of the property should have been abandoned during such period or that it become certain that the property must be abandoned at a definite future date. Therefore, where the use of property is continued in a related enterprise under the same ownership, there is no abandonment,

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[10] For regulations, rulings and illustrations see *Income Tax Procedure*, 1920, pages 743-749.

nor is it possible to say at the time of conversion that the property must be abandoned.

Amounts expended in remodeling a building for the manufacturing of a different product are capital expenditures and can not be taken as a loss or an expense. (B. Digest 34-21-1780; O. D. 1001.)

The foregoing ruling is not sound, if as appears, the brewing company intended to abandon its business upon prohibition becoming effective and entered upon the manufacture of cereal beverages while awaiting the future of the Volstead Act. It would have been easy to go through the form of a sale, and thus do indirectly what the law allows as a direct deduction. Taxpayers cannot be penalized for an attempt to secure a temporary use of property, the effect of which is beneficial both to taxpayers and the government.

VINEYARDS.—

RULING. No deduction representing extraordinary loss due to prohibition legislation is allowable in the case of vineyards unless such legislation necessitates the abandonment of the vineyard. If the vineyard is abandoned, the amount deductible as a loss is the cost of the vineyard, or its fair market value as at March 1, 1913, if acquired prior to that date, plus cost of subsequent improvements, less any depreciation previously charged off and any salvage value. No deduction is permitted on account of land. If, by reason of legislation passed in 1918, the abandonment of the vineyard occurs in 1919, the loss deduction may be equally divided between 1918 and 1919, since the law prohibits the utilization of the 1919 crop, and 1919 income is to be attributed to the manufacture and sale of vintage of 1918 and earlier years. (C. B. 1, page 125; O. D. 102.)

GOODWILL.—

RULING. Where a corporation engaged in the wholesale liquor business continued to make sales in 1918 it will not be permitted to deduct in its 1917 return an amount representing the entire value of its good will since it did not actually sustain a determinable loss of such amount in the year 1917. (C. B. 3, page 156; A. R. R. 185.)

The comments made above on the Treasury's ruling that where a related business is continued no deduction for obsolescence is permitted, also apply as to the following:

RULING. Liquor dealers who continued in a similar trade or business after prohibition legislation became effective are not entitled to a

deduction for obsolescence of their intangibles such as good will, trade-marks, and trade brands. (C. B. 4, page 178; O. D. 818.)

The Committee has ruled in a recent case that the good-will of an agent for wine-growers was of a personal nature and for that reason no claim for obsolescence could be made.

Ruling. The Committee has had under consideration the appeal of A from the action of the Income Tax Unit in disallowing as a deduction from gross income in 1918 an item of $42x$ dollars, representing a deduction for obsolescence of good will.

The record indicates that A filed a return for the calendar year 1918 disclosing a net income of $48x$ dollars and a tax due of $9x$ dollars. A claim for abatement in amount of $3x$ dollars was filed in September, 1919, against the unpaid balance of tax due on the original return for 1918, and a claim for refund of $6x$ dollars, the amount paid on the original return for this year, was also filed. Subsequently a claim for credit of x dollars was filed, which was the amount of tax due on the 1919 return of the appellant, with a request that the claim for refund be reduced by this amount.

The claims were based on a deduction for obsolescence of good will as of March 1, 1913, which amount was computed by determining the average profit and invested capital for the years 1905 to 1912, inclusive, allowing a 6 per cent return on the average invested capital for this period and capitalizing the excess on a 10 years' purchase basis. The amount thus determined was then prorated over a period of 23½ months from February 1, 1918, to January 16, 1920, and 22/47 of the total applied as a deduction in the year 1918. The claims thus filed were rejected by the Income Tax Unit for the reason that the evidence showed the appellant to be engaged in a business similar to the liquor business and accordingly the good will could not be considered obsolete.

During the year 1918, and for approximately 30 years prior thereto, the appellant was engaged in the business of a merchandise broker, acting as agent for wine growers and selling only to the largest wholesale liquor dealers. The business, which started from nothing, increased from year to year until in the year 1917 the sales amounted to about $36x$ gallons. In the year 1918, with prohibition threatened, sales dropped to $22x$ gallons, and in 1919, with prohibition assured, sales approximated $2x$ gallons. The appellant was able to do a considerable volume of business between April and November of 1920. However, this business was done with one customer, all of his other customers having liquidated and gone out of business prior to January 16, 1920. It was stated at a hearing held before the Committee that the one customer who remained in business after January 16, 1920, is now understood and generally believed to be

liquidating and preparing to go out of business. No sales have been made to this customer since 1920. The appellant was able to make a few scattered sales during 1921, but they were not sufficient to meet the nominal expense of maintaining an office.

The principal asset of the business was the good will which the appellant built up by reason of his knowledge of conditions and characteristics peculiar to the wine business during the long period he was engaged in business. The good will thus established, it is contended, is now, due to adverse legislation, practically worthless. All but one of his former customers are out of the market and prospects for the future business are uncertain and problematical. It is not expected that the few sales it is possible to make will be more than sufficient to meet the nominal expense of maintaining an office.

Section 214(a) of the Revenue Act of 1918 provides—

That in computing net income there shall be allowed as deductions:

* * * * * * *

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

The question as to the deductibility of obsolescence of intangible assets, such as good will, trade-marks, trade brands, etc., was decided in T. B. R. 44 (C. B. 1, p. 133), wherein it was held that a deduction for obsolescence of intangible assets may, within certain definite limitations, be taken in computing taxable net income. The Committee, in Memorandum 34 (C. B. 2, p. 31), has outlined a method which, in the absence of better evidence, may be utilized in determining the value of intangibles as of March 1, 1913.

Inasmuch as the question of the deductibility of obsolescence of good will has been decided in the affirmative and a practical method has been suggested for the determination of its value (when not specifically paid for as such), it would appear that in the instant case the only question for the Committee to decide is whether the foregoing facts afford the appellant a basis for claiming obsolescence of good will as a deduction.

In order to sustain such a claim it is essential that the value of the good will, in respect of which a deduction for obsolescence is claimed, has been destroyed or will be destroyed by prohibition legislation; that the good will in question is assignable as an asset and that it will not be valuable in continuing a lawful business after prohibition becomes effective.

There is unquestionably no doubt that due to the enactment of adverse legislation the appellant will ultimately be forced to abandon his business as a profitable means of making a livelihood. The sales made by the appellant in 1921 were hardly sufficient to meet expenses, and with prospects no better for the year 1922, it is apparent that the

natural processes of the prohibition laws have finally accomplished what they set out to accomplish. It is true that this result was not finally effected on January 16, 1920, as might have been expected. The first stages of decay set in about the beginning of 1918. They were not so clearly seen then as they are now but the processes were at work continuously and culminated when prohibition was enforced, although by reason of temporary liberal administration of the law the surface indications were not finally extinguished until 1921. In the opinion of the Committee the foregoing conditions lead to a reasonable assumption that the business of the appellant has been destroyed by reason of prohibition legislation.

The good will built up by the appellant during the long period he was engaged in business, in the opinion of the Committee, would be of little or no value in carrying on a lawful business not affected by prohibition legislation. With one exception all of his former customers are out of business, and with his experience and knowledge restricted to the commercial traffic in wine it is exceedingly doubtful that the good will developed in connection with the operation of his former business would be of value in carrying on a legitimate enterprise.

The principal factor contributing toward the success and prosperity of the appellant's business was the knowledge of conditions and characteristics peculiar to the wine business gained by him during many years of experience. Likewise, the principal asset of the appellant is attributable to the same fund of knowledge. There was apparently no competition in the particular business of the appellant. Practically all of his sales were made to less than 20 customers. The success and prosperity of the appellant depended entirely upon his ability to capitalize his principal asset, which, by reason of its peculiar and personal character, could not have been separated from him. The Committee has carefully considered the nature of the good will claimed by the appellant and has come to the conclusion that it is of such a personal character as to be without value as an assignable asset and accordingly fails to meet the most essential test necessary to sustain a claim for obsolescence of good will.

It is, therefore, recommended in the appeal of A, that the action of the Income Tax Unit in disallowing an item of 42*x* dollars, representing a deduction for obsolescence of good will, be sustained and the appeal accordingly denied. (I-4-42; A. R. R. 722.)

Amortization of Plant, etc., Used for War Purposes

The 1921 law re-enacts the provisions of the 1918 law with respect to a deduction for amortization of war facilities, but contains two important changes:

1. The time limitation on the deduction is fixed at March 3, 1924.
2. Claim for amortization must be filed not later than date for filing 1921 return.

LAW.[11] . . . . In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefore was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Act of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252; . . . .

In accordance with a Joint Resolution of Congress dated March 3, 1921, the latter date is to be considered as marking the termination of the war between the United States and Germany, and for purposes of the 1918 law is held to be the date from which the three-year period for amortization purposes runs.[12] Since taxable years may not end on any day except the last date of the month,[13] the new regulations state the limitation date as February 29, 1924, (article 181).

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[11] Section 214 (a-9), individuals; section 234 (a-8) corporations.

[12] Letter dated March 22, 1921, signed by Carl A. Mapes, Solicitor of Internal Revenue.

[13] See page 64.

Deductions may be made in returns up to February 29, 1924.—

Regulation. An allowance for amortization may be deducted only in returns filed for taxable years ending on or before February 29, 1924. . . . . (Art. 181.)

When claim for amortization must be filed.—Returns for 1921 on the calendar year basis are due March 15, 1922. In the case of fiscal years ended in 1921 it is believed that the Treasury will extend to them the same privilege as accorded calendar year taxpayers, and accept amortization claims within a reasonable period. It is advisable to submit claims on or before March 15, 1922, that being the date which calendar year taxpayers are supposed to observe. If it is not feasible to file claims by that date, extensions of time should be requested.

Regulation. . . . . Such allowance with respect to any period of time subsequent to December 31, 1920, may be deducted only if a claim for amortization (unmistakably differentiated from all other claims for wear, tear, obsolescence, and loss) was made at the time of filing the return for the taxable year 1918, 1919, 1920 or 1921. . . . . (Art. 181.)

Any extensions of time for filing 1921 returns will automatically extend the date when final claims may be filed.

The regulation is not clear as to the period affected by the final claims. The regulations cannot limit the deduction which the law allows. It is clear that the deduction is for "any" taxable year commencing with 1918 and ending February 29, 1924. The gross income against which the deduction applies depends on the facts of each case.

Meaning of "amortization."—To amortize means "to destroy; kill; deaden."[14] Therefore a reasonable deduction for amortization means a deduction sufficient to destroy or kill or deaden the values on the books which represent plant or equipment used for war purposes. If the effective or usable

[14] *Standard Dictionary.*

value has disappeared entirely, the book value must be entirely killed (amortized). If the effective or usable value has only partly disappeared, the book value must be killed (amortized) to an extent which will leave a remaining book value representing only the actual worth of the asset.

The law is not ambiguous, but if it were, the statement of Senator Simmons, made in respect to the similar provision under the 1918 law, would make clear the proper method of determining the amount of amortization which the law allows.[15]

Procedure under the Treasury Regulations

No part of the field of income tax procedure has been so prolific of different sets of regulations as that of amortization. The preliminary regulations were issued soon after the 1918 law was passed, and reflected the wording of the law. The regulations issued April 17, 1919, attempted to narrow the scope of the deduction. The Treasury evidently considered that the first regulations were too liberal, and regretted it. Next came T. D. 3123 (issued January 28, 1921) which recognized that the amortization deductions, instead of being allocated entirely to 1918 and 1919, might be extended to subsequent years. Finally, we have a fourth set of regulations under the 1921 law.[16]

What the taxpayer must show.—The successive steps under the new regulations may be summarized as follows:

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[15] Senator Simmons in discussing this point in the Senate, February 11, 1919, said:

"I can answer the Senator generally by saying that if by reason of the investment of his profits in an extension of his yards he has constructed a plant which was necessary in time of war to meet the demands which were made upon him at that time for production, but which after the termination of the war has depreciated in value because not needed; in that case, under the amortization provision he will be allowed to amortize to the full extent of the depreciation in value. Of course, if there is salvage he would be allowed to amortize only down to the salvage value." (*Congressional Record*, February 17, 1919, page 3774.)

[16] For details of prior regulations and rulings, see *Income Tax Procedure*, 1921, pages 907-922.

(a) Statement of facilities to be amortized must show that they were constructed, erected, installed or acquired on or after April 6, 1917.

(b) The facilities in (a) were for the "production of articles contributing to prosecution of the war," and in the case of vessels "for the transportation of articles or men contributing to the prosecution of such war."

(c) Classification of the facilities under (a) into those

(1) Sold or discarded, or which will be sold or discarded before March 3, 1924.

(2) Retained as part of the taxpayer's going business.

(d) Valuation of property in (c):

(1) Items in (c-1) are taken at actual sale price, or at estimated fair market value at date property will be sold or discarded.

(2) Items in (c-2) are taken at estimated "value in use" to taxpayer.

(e) Cost less value in (d) will give total amortization deduction which is spread over the

(f) Amortization period, divided as follows:

(1) For property in (c-1): "Between January 1, 1918[17] and the date when the property was or will be sold or permanently discarded as a war facility" (article 185).

(2) For property in (c-2): "Between January 1, 1918[18] and the actual or estimated date of cessation of operation as a war facility" (article 185).

(g) The amortization deduction (e) separately computed as to the two classes of property in (c) is spread over the amortization period (f) in the proportion that the net income (computed without benefit of the amortization allowance) for

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[17] ". . . . or if the property was acquired subsequent to that date, January 1, of the year in which acquired" (article 185).

[18] *Ibid.*

each of the years in the amortization period (f) is to total net income of such period. When there are both classes of property i.e., (c-1) and (c-2), to be considered, the amortization period must be computed separately for each class of property.

Meaning of term "articles contributing to the prosecution of the war."—

REGULATION. . . . . The allowance may be deducted only by taxpayers who after April 6, 1917, have constructed or otherwise acquired plant or other facilities for the actual production of articles contributing to the prosecution of the war. It is not sufficient, to entitle the taxpayer to the allowance, that the nature of his business is such as to contribute to the production of articles. For example, a taxpayer, such as a railroad, whose business activities are confined to transportation (other than water transportation) is not entitled to the allowance. A taxpayer, the nature of whose business is the actual production of articles, however, may claim the allowance with respect to the cost of all buildings, machinery, equipment or other facilities which were constructed for use or which were used in connection with the production of such articles, both in the acquisition and transportation of raw material, the actual process of manufacture or other conversion, and the transportation and marketing of the finished product. . . . . (Art. 183.)

The changes in the foregoing regulation are based on a decision contained in B. 45-21-1909; L. O. 1074. The second sentence of the regulation is restrictive to a degree not justified by the opinion which follows:

RAILROAD DENIED AMORTIZATION DEDUCTION.—

RULING. . . . . The M railroad at the breaking out of the war was doing a normal business for a road of its size. In 1915 certain manufacturers constructed various plants in the vicinity of the road. It is stated that the only outlet for the productions of these plants was the M railroad, and, in order to enable the road adequately to handle the output of such plants, as well as to transport thousands of workers to and from their work, it was necessary for it to provide additional facilities. From the year 1915 the railroad's expenditures for additional facilities, consisting of tracks, stations, additions to stations, locomotives, and passenger cars steadily increased, and in 1917 they amounted to $1\frac{1}{2}x$ dollars, which was increased in 1918 by an expenditure of $3\frac{1}{3}x$ dollars. It was found impossible to obtain

the services of the O company's repair shops, and, by reason of the refusal of that company to make such repairs, it became necessary for the railroad to erect certain buildings and plants. The taxpayer calls attention to the fact that these facilities, necessitating this additional investment, were absolutely necessary in the prosecution of the war, and that they were constructed and acquired solely for war purposes. . . . .

It is recognized by Congress that the phraseology used in the statute in regard to the amortization allowance on buildings, machinery, equipment, and war facilities is not sufficiently broad to admit of an allowance of facilities used for transportation. The Act as originally passed by the House, ... in respect to amortization, ... did not contain the language in respect to ships now found in the statute but provided for the allowance in the following language:

In the case of buildings, machinery, equipment, or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war there may be allowed a reasonable deduction for the amortization or such part of the cost of such facilities as has been borne by the taxpayer, * * *.

In the report of the Senate Committee on Finance dated December 6, 1918, the following remarks are made in respect to amortization:

In the paragraph relating to amortization allowance (section 214 (a) and section 234 (a) 8), it was feared that the language was not broad enough to include vessels devoted to war purposes, and provision has therefore been made for amortization allowance in the case of vessels constructed or acquired on or after April 6, 1917, for the transportation of articles or men contributing to the prosecution of the present war.

The amendment referred to in the Senate committee report resulted in the existing provisions of the statute.

Therefore, Congress recognized that the language used in the first part of the section was not sufficient to embrace transportation facilities and advisedly broadened the section only in so far as to include ships.

While the additional facilities purchased by the M Railroad Company enabled it to meet the extraordinary demands occasioned by the war, they are not such facilities as may be said to have been used for the production of munitions manufactured by the companies whose plants were built in the vicinity of its right of way. Transportation can not be regarded as a part of production and this is evidently the construction which Congress intended should be put upon the statute. . . . . (B. 45-21-1909; L. O. 1074.)

In the foregoing ruling the legislative history of the 1918

law is reviewed. The provision in the 1921 law is similar. The conclusion is drawn that, since Congress had feared the 1918 law might not fully cover vessels and made specific provision therefor, other types of transportation are excluded. The author believes this conclusion is not justified by the wording of the law, and is a very narrow interpretation which will not be substained by the courts.[19] Congress has evinced a disposition to deal more liberally with the amortization question. For example, note the following which explains the extension of the privilege of the amortization deduction to those making at time of filing the 1920 and 1921 returns. The House had originally limited it to those filing claims with their 1918 and 1919 returns.

Amendment No. 188.[20] This amendment inserts, for the reason explained in connection with amendment No. 3, the paragraph of existing law relating to the deduction for amortization of war facilities and vessels but limits such deduction to any taxable year ended before March 3, 1924, and allows it for such years only if claim was made at the time of filing return for the taxable year 1918 or 1919. The House recedes with an amendment permitting the deduction also in the case of claims filed at the time of filing returns for the taxable years 1920 and 1921.

The only statement of importance in the opinion is that the facilities of a railroad cannot be said to have been acquired "for the *production of articles* contributing to the prosecution of the war." The opinion holds that it was the specific reference to vessels which had more bearing than any other factor in the case. In another case it probably will be found that the words "contributing to" will be the controlling factor.

When amortization is permitted it must relate to plant or equipment acquired "for the production of articles contributing to the prosecution of the war." The words "contributing to" are almost the broadest and most elastic

[19] The *Standard Dictionary* defines "article" as a particular object or substance; as an article of food.

[20] Extract from *Conference Report* (Representative J. W. Fordney), November 19, 1921, page 25, explaining the amendment of the amortization provision, section 214 (a-9).

which could be used. If a mining company, after April 6, 1917, erected a new smelter which was used to smelt copper ore, which in turn went to a refinery, then to brass works, then to an automobile company for use on a truck, which was used to transport goods on the highways to relieve the freight congestion, the smelter undoubtedly contributed to the prosecution of the war. The evidence here is that through the War Industries Board copper was supposed to be allotted only to those who were engaged in essential industries.

Any industry which was regulated by the War Industries Board can secure evidence as to the degree of its contribution. J. Leonard Replogle, chief of the steel section of the Board, said that steel for corset stays and poker chips was unessential. That would be evidence competent to eliminate the manufacturers of corsets and poker chips from the benefits of the amortization privilege. Between manufacturers of these luxuries or so-called non-essentials and the manufacturers of rifles there is too broad a range to permit one to lay down a definite rule.

The War Industries Board issued priority certificates and clearance privileges to those who were deemed to be contributing to the prosecution of the war. In some cases if a small surplus of raw materials existed it was allotted to uses which were not deemed to be essential. Fuel and transportation were denied to those whose products were deemed to be of less importance than others. At no time during the war, however, was any authoritative list prepared which furnished complete information. About the time of the signing of the Armistice certain lists had been prepared and others were in process of preparation defining less essential products.

Each taxpayer is entitled to prepare his own case and make claim based on the conditions which actually confronted him at and after April 6, 1917.

Building permits were difficult to obtain and the purchase of equipment was even more difficult. The mere fact that a permit was secured or machinery was purchased and installed

after, say, January, 1918, is, in the opinion of the author, *prima facie* evidence that the new plant or additions to existing plant or the new equipment or additions to existing equipment were for the purpose of contributing to the prosecution of the war. Prior to that time restrictions were not in force, except to a limited extent, but the demand for war materials was so great and the sentiment against non-essential work so strong that at almost any time after April 6, 1917, the mere fact that buildings were erected and machinery was purchased is strong evidence that they were intended to contribute to the prosecution of the war. The cost of buildings and equipment was so much above pre-war prices that those who were not engaged in war work were deterred from making commitments.

RULING. Machinery, equipment, or other facilities erected or acquired on or after April 6, 1917, for the production or manufacture of sugar is considered as contributing to the prosecution of the war, and the cost may be amortized in accordance with the provisions of section 234 (a) (8) of the Revenue Act of 1918. (C. B. 1, page 221; O. D. 259.)

Property which may be amortized.—The general provision is similar to that in the old regulation.

REGULATION. The taxpayer may deduct from gross income a reasonable allowance for amortization of the cost of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war. . . . . (Art. 183.)

It may be assumed that the words "German Government" are fully inclusive of the Austrian Government.

REGULATION. . . . . In the case of facilities the construction, erection, installation or acquisition of which was commenced before April 6, 1917, and completed subsequent to that date amortization will be allowed with respect only to that part of the cost incurred on or after April 6, 1917, and which was (or should have been) properly entered on the books of the taxpayer on or after that date. (Art 183.)

In the regulations provision is not made for war facilities acquired prior to April 6, 1917, (the date of our entrance into the war). Facilities acquired before that date for war work for the other Allied nations would seem therefore to be excluded, even though subsequently used to produce articles for the United States government.

No limit is set on the date *after* April 6, 1917, that war facilities might be acquired. For example, if contracts for buildings were entered into prior to the Armistice and the work was not completed until 1919, amortization could still be claimed on such building.

Allowances for amortization as part of cost or in settlement of claims to be included in income.—

REGULATION. . . . . All allowances made to a taxpayer by a contracting department of the Government, or by any other contractor, for amortization specifically as such, shall be treated as a reduction of the cost of the taxpayer's plant investment. Further amortization is allowable only in respect of such reduced cost. Where no such allowance has been made the amount of amortization to be allowed as a deduction from gross income, for the purpose of the tax, shall be computed in accordance with the provisions of articles 181 to 189, pursuant to which the deduction must be made, and not upon the basis of any amount contractually or otherwise determined. (Art. 181.)

The foregoing regulation is in accord with the law and with good accounting practice.

The regulation recognizes amortization which has been allowed by some other department of the government. The refusal of the Treasury prior to 1922 to accept settlements made by the War and Navy Departments occasioned much difficulty in the preparation of claims. Taxpayers are justified in placing great weight on appraisals and allowances officially determined by the government. It will be found that the courts will place equal weight on such settlements. Nevertheless it is within the power of the Commissioner to require that all claims for amortization be submitted in a form acceptable to the Treasury, provided always that the requirements are

reasonable. If not reasonable, taxpayers should submit claims conforming to the law itself. Obviously the regulations should be complied with to every possible extent. If the settlements by the War and Navy Departments do not reflect the full amortization contemplated by the 1918 and 1921 laws, the limitation in the regulations may be ignored.

Depreciation allowances.—

REGULATION. The allowance for amortization shall be inclusive of all depreciation during the amortization period on property subject to amortization. (See art. 186.) Depreciation will be allowed, beginning at the close of the amortization period, upon property the cost of which has been partly amortized, but shall be limited to the value of such property after the amortization allowance has been deducted. Property which has been amortized to its scrap value shall not further be subject to depreciation. (Art. 182.)

The old regulation (before amendment in 1921) contained the clause, "Depreciation for any taxable period after December 31, 1917 should, therefore, not be claimed with respect to property as to which an allowance for amortization is claimed." Taxpayers were led to believe that depreciation could not be claimed on the unamortized balance of property with respect to which amortization had been claimed in 1918 and 1919 returns. The new regulation omits this clause and there is now no doubt that depreciation on any unamortized property can be claimed the same as on any other depreciable property.

Computation of loss.—

REGULATION. The total amount of the amortization allowance is the difference between the original cost of the property if constructed, erected, installed, or acquired on or after April 6, 1917; or if acquired partly before and partly after April 6, 1917, then that part of the cost incurred on or after April 6, 1917, and properly entered on the books of the taxpayer on or after that date, less any amounts deducted for depreciation, losses, etc., prior to January 1, 1918, and the value of the property on either of the bases indicated below:

(1) In the case of property which has been sold or permanently discarded, or which will be sold or permanently discarded before

March 3, 1924, the value shall be the actual sale price or estimated fair market value as of the date when the property was or will be permanently discarded, plus a reasonable allowance for depreciation in case the property is used in the taxpayer's business after the close of the amortization period. Such fair market value shall be established by investigation of engineers of the Bureau of Internal Revenue, if such investigation is deemed advisable.

(2) In the case of property not included in (1) above, the value shall be the estimated value to the taxpayer in terms of its actual use or employment in his going business, such value to be not less than the sale or salvage value of the property and not greater than the estimated cost of replacement under normal postwar conditions less depreciation and depletion. Upon the basis of the costs prevailing at the latest prewar date at which a reasonably normal market existed, the Commissioner shall in respect of basic material and labor costs determine and publish ratios of estimated postwar costs of replacement, and a taxpayer shall use such ratios in computing a claim for a tentative allowance for amortization. Such tentative allowance may be redetermined on or before March 3, 1924, at the request of the taxpayer or by the Commissioner.

Special record of all property falling in (1) above, must be preserved by the taxpayer, and the Commissioner must be notified with the next tax return (*a*) if, after having been in good faith permanently discarded or dismantled, property shall in any case be restored to use because of conditions not foreseen or anticipated at the time it was discarded; or (*b*) of the selling price, if sold. (Art. 184.)

Property described in clause (1) of article 184 is that sold or discarded, or which will be sold or discarded before March 3, 1924.

Property described in clause (2) of the same article is that retained as part of the taxpayers' going business.

The principal change in the new regulation as compared with that issued as part of T. D. 3123 (issued January 28, 1921)[21] is the elimination of sentence reading: "for the purpose of returns made in 1919, the preliminary estimate of the amount of such amortization shall not, in any case, have exceeded 25% of the cost of the property." The author contended that such a provision was not legal.[22]

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[21] **[Former Procedure]** T. D. 3123 (Art. 184) eliminated the restrictive clause limiting the deduction for facilities it was known would be discarded in the future, to those to be discarded "before the last installment payment of the tax" covered by the 1919 returns.

[22] See *Income Tax Procedure*, 1921, pages 920-922.

Also the reference to determining the amortization allowance "upon the basis of stable post-war conditions" has been modified. As the author stated in a previous edition, no one seems to have been able to advise taxpayers what are "stable post-war conditions." The reference to pre-war data is interesting, and if fair to taxpayers may be accepted as a reasonable method of fixing stable post-war prices.

Period to which loss is apportioned.—

Regulation. The amortization allowance shall be apportioned (a) in cases where the property was employed in the production of articles contributing to the prosecution of the war, over the respective accounting periods of the taxpayer, having reasonable regard to his gross and net income, and where separately ascertainable the income from the facilities upon which amortization is claimed, between January 1, 1918 (or if the property was acquired subsequent to that date, January 1 of the year in which acquired), and the actual or estimated date of cessation of operations as a war facility, and (b) in cases where the property was not completed in time for use in the production of articles contributing to the prosecution of the war, on the basis of the expenditures made on account of which amortization is allowed. . . . . (Art. 185.)

Estimate of net income for "amortization period" required—basis of apportionment.—

Regulation. . . . . All taxpayers claiming an allowance for amortization shall compute the amount of their claims applicable to each accounting period between January 1, 1918, to the date specified above. Taxpayers reporting on the fiscal year basis shall (*a*) in all computations based upon 1918 rates for years ending in 1918 and 1919 use the amount of such allowance apportioned to the calendar year 1918; (*b*) in all computations based upon 1919 rates for a year beginning in 1918 and ending in 1919, use the amount of such allowance apportioned to the calendar year 1919; (*c*) in all computations for a year beginning in 1919 and ending in 1920, use the number of twelfths of the allowance apportioned to each calendar year falling within such fiscal year that there are months of such calendar year falling within such fiscal year; (*d*) in all computations based upon 1920 rates for a year beginning in 1920 and ending in 1921, use the amount of such allowance apportioned to the calendar year 1920; (*e*) in all computations based upon 1921 rates for years ending in 1921 or 1922, use the amount of such allowance apportioned to the

calendar year 1921; (*f*) in all computations based upon 1922 rates for a year beginning in 1921 and ending in 1922, use the amount of such allowance apportioned to the calendar year 1922; (*g*) and in all computations for subsequent fiscal years use the number of twelfths of the allowance apportioned to each calendar year falling within such fiscal year that there are months in such calendar year falling within such fiscal year. (Art. 185.)

The law imposes no limitation on the amount of amortization to be deducted in any one year, nor does it state that the entire amortization must be claimed as a deduction against one year's income. The intent of the law would seem to be to permit taxpayers who erected plants for war purposes to write off, as quickly as possible, the excess cost of such plants over normal or pre-war cost and to apply such write-off in reduction of income reported for taxation. Until such excess cost has been written off there is no income which should be taxed. Until the excess has been written off such taxpayers are not on an equal basis with other taxpayers who constructed their plants before the war and made no new capital expenditures to assist in the prosecution of the war. Furthermore the deduction for amortization is not actually being fully allowed if in part or in whole it is included in a tax return to an amount in excess of the net income determined prior to the application of the amortization deduction.

Assuming that the amortization allowance exceeds the net income of 1918, it would seem logical to apply the net income of each year from 1918 onward against the amortization allowance and to tax income only after the amortization has been fully applied against income.

It would of course defeat the purpose of the relief intended if a taxpayer were required to take the amortization deduction in a period when he had no net income. Such was not the intention of the law. It was assumed that war facilities produced an income while being used and that if their profitable use was diminished by the end of the war there should be an adjustment of the apparent profits equal to the loss sustained.

If a taxpayer required several months in 1919 to secure a market or use for war facilities and during those months the facilities were not producing a profit, the entire loss should be charged to 1918.

The method laid down in article 185 may work equitably in some cases. If the application of the method to a particular case does not yield to the taxpayer a reasonable deduction for amortization, some other method should be used.

Taxpayers should prepare an estimate of the loss sustained and then apply the loss to the period affected. The accounts should be adjusted accordingly and if the result is not the same as would be produced by the conflicting methods in the regulations the taxpayer will have to look to the courts for a correct interpretation of the law.

Taxpayer's books and statements.—

REGULATION. Claims for amortization must be unmistakably differentiated in the return from all other claims for wear, tear obsolescence, and loss. If Government or other contracts taken by the taxpayer contained recognition of amortization as an element in the cost of production, copies of such contracts shall be filed with the taxpayer's return, together with a statement and description of any sums received on account of amortization and the basis upon which they were determined. In any case in which an allowance has been made for amortization of cost the taxpayer will not be allowed to restore to his invested capital for the purpose of the war-profits and excess-profits tax any portion of the amount covered by such allowance. (Art. 186.)

The statement in the old regulation that, "No such claim will be allowed unless it is reflected in any accounts submitted by the taxpayer to stockholders and in any credit statements by the taxpayer to banks, and is given full effect on his financial books of account," is eliminated.

It is a reasonable requirement that a taxpayer's books should reflect all transactions. When claim for amortization is made, the loss should (so far as feasible in advance of final determination of the allowances) be charged against the period to which it belongs.

In submitting final claims which may modify prior claims and an early adjustment of the whole matter is contemplated, it may be desirable to await final adjudication before making further adjustments in the books.

Estimates to be adjusted before March 3, 1924.—

REGULATION. A redetermination of the deduction allowed on account of amortization may, or at the request of the taxpayer shall, be made by the Commissioner at any time before March 3, 1924, and if as a result of an appraisal or from other evidence it is found that the deduction originally allowed was incorrect, the amount of tax due for each taxable year during the amortization period will be adjusted by additional assessment or by refund. (Art. 187.)

It should always be kept in mind that the original claim was based on an estimate, except in the case of sale or some other definite means of determination.

Taxpayers may present to the Commissioner their claim for a redetermination at any time prior to March 3, 1924.[23] Until the Commissioner announces his final determination, taxpayers need not consider the matter is ready for final adjudication. When such final determination is announced, taxpayers have a statutory right of appeal, at which time, and not before, the rights of taxpayers to revise their claims will end.

When it is found that the estimate was too large or too small the facts should be reported without delay and the taxes of the prior years should be redetermined.

When an original estimate of loss proves to be excessive, because facilities believed to be of lessened value at the end of the taxable year 1919 have subsequently increased in value, amended returns should of course be made.

But if on subsequent sale facilities should be sold for more than book value, exclusive of amortization, the profit realized should be reported as of the period of sale and only the amount of amortization restored to the original period. This

[23] See also C. B. 1, page 140; A. R. M. 10.

accords with the usual rule that appreciation in value should not be reported until realized.

REGULATION. In the case of the bona fide sale of amortized property before March 3, 1924, the sale price thereof will be considered as reflecting the correctness or incorrectness of the amortization allowance made, due allowance being made for depreciation sustained since the close of the amortization period. (Art. 188.)

Detailed information to support claim must be filed.—

REGULATION. The taxpayer's claim for amortization must be complete and comprehensive in all respects. The commissioner will not entertain claims which do not clearly set forth full data with respect to the property which it is desired to amortize.

To assist the taxpayer in compiling this information the Commissioner has prepared Guide Form 1007-M, which explains in detail the manner in which claims for amortization should be presented. A copy of this guide form will be furnished to the taxpayer upon application to the Commissioner. (Art. 189.)

The Treasury requires comprehensive data as to original cost, depreciation sustained, when acquired or constructed, proof as to "value in use," and the various computations necessary to allocate the deduction to the proper years. A copy of the Guide Form 1007-M referred to above will be found in the Appendix.

CHAPTER XXXIII

DEDUCTIONS FOR DEPLETION

The 1921 law re-enacts the provisions of the 1918 law regarding depletion. "A reasonable allowance for depletion" is permitted in the case of those industries with wasting assets because of the exhaustion of the minerals, oil, timber, etc. The allowance represents a return of capital. While the provision permitting a "discovery" value as a basis for depletion (in case of properties "discovered" on or after March 1, 1913) is retained in the new law, a limitation on securing the benefit of the full amount of such depletion is now imposed. The effects of this limitation are (a) to prevent carrying forward into a succeeding year (as a net loss—see section 204) any excess of depletion based on "discovery" value over net income from the property, and (b) to deny the offsetting of such excess depletion against income from other sources, such as income from investments or from the operation of another property. In the case of oil wells, the "discovery" feature is doubtless invoked in respect of many properties acquired since March 1, 1913. As in so many of the other so-called "cushion" provisions of the income tax laws, Congress having first given the taxpayer relief in one provision, proceeds to take away, in another provision, much of the benefit. On the other hand, it may be assumed that "discovery" values may well be so high that the depletion charge, in a year of depression, may easily exceed all income from the property. In any event the taxpayer will receive the benefit of "discovery" depletion up to the amount of the income from the property, should such depletion be greater than the income from the property.

LAW. Section 214. (a-10) [Individuals] Section 234. (a-9) [Corporations.] **That in computing net income there shall be allowed as deductions:**

In the case of mines, oil and gas wells, other natural deposits,

and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; . . . .[1]

Nothing more could be asked by any owner or lessee of natural deposits than "a reasonable allowance for depletion," but the interests of lessor and lessee should be separated.

The theory of depletion is comparatively simple, viz., provision must be made for the return of capital invested in natural resources which are being exhausted. The capital to be returned is original cost, or value as at March 1, 1913, if acquired prior thereto, or in certain cases a "discovery" value if acquired after March 1, 1913. This involves a periodical charge against the gross earnings realized from the product, of such amounts as will in the aggregate equal the original outlay by the time the property shall have been exhausted. It is in the application of the theory, or rather in securing the

[1] **[Former Procedure]** The 1921 law is the same as the 1918 law, with the exception that the clause, "*And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913;" did not appear in the 1918 law.

requisite data, that the practical difficulties are encountered. Two fundamental facts must be established, as follows:

(a) Value of the property at March 1, 1913, if acquired prior thereto, or within thirty days after "discovery" if acquired after March 1, 1913;[2] and
(b) The number of units of principal product in the property at valuation date.

The depletion unit [a ÷ b] multiplied by the number of units produced during the year, gives the depletion deduction for the taxable year.

As soon as the reserve for depletion equals the capital investment, no further charges can be made, no matter how much more product may be recovered. The excess is all income and must be so returned.

The language of the 1921 law[3] is broad enough to permit the full deduction demanded by the theory of depletion.

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[2] If the property was acquired after March 1, 1913, and no "discovery" value is claimed, cost is used as factor (1).

[3] [Former Procedure] Under the 1909 law no deduction could be made for depletion. The language of the statute that "all losses sustained within the year . . . . including a reasonable allowance for depreciation of property" (section 38, Second) was interpreted by the Supreme Court of the United States as not permitting the deduction of allowances of this type (*Von Baumbach, Collector, v. Sargent Land Co.*, 242 U. S. 503). The Bureau of Internal Revenue, acting upon this decision, reassessed corporations which under this law claimed depletion allowance. For a full discussion and criticism of this decision see *Income Tax Procedure*, 1918, pages 406-408.

The 1913 law permitted "in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed 5 per centum of the gross value at the mine of the output for the year for which the computation is made" [section II G (b)]. The Supreme Court of the United States held that this 5 per cent limitation was constitutional even though it might be inadequate to provide fully for depletion and as a consequence might result in the tax being levied not only on the profit but also in part upon gross product or capital. (*Stanton v. Baltic Mining Company*, 240 U. S. 103.) For a full discussion of the procedure under this limitation of the 1913 law, see *Income Tax Procedure*, 1918, pages 402-406.

The latest regulations[4] of the Treasury reflect the general principles to be observed in arriving at proper valuation, the determination of the proper number of mineral units embraced therein, and proper depletion charges.

The major problem, however, is to assemble the tremendous amount of data required to support the valuations to the satisfaction of the Treasury. Fortunately, many mining companies have excellent records from which the data regarding assay values, recovery of metal contents, costs, proper rates of discounts in the case of mines, and the other factors can be compiled and stated.

In arriving at the depletion rate, consideration must also be given to the effect that the value established for depletion may have on invested capital, particularly as to paid-in surplus,[5] as well as its effect on the distributions to stockholders in the form of dividends free from tax.[6]

Practically, it will be found in every case that where an attempt is being made to establish the proper depletion rate, a series of problems, as indicated above, follows in the train of what theoretically is quite a simple matter. When a company owns a series of mining claims it is often a question as to how much should be taken in, in those cases where the ore is not blocked out, and how much, if any, in the future may be brought in under the discovery provision.

The 1916 law, unchanged in 1917, [section 5, Eighth (a), individuals, and section 12 (a), Second, corporations] was as follows:

"(a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. . . ."

[4] Reg. 62, promulgated February 15, 1922.

[5] See Appendix A, Chapter X.

[6] See page 715.

Depletion, at the option of the taxpayer, is made to embrace recovery of capital expenditures other than for ore, and this gives rise to questions of what are really capital items in a business of the character peculiar to wasting assets, and what is properly chargeable to expense.

General procedure in case of depletion.—

Basis of depletion allowance.—The first step in determining the depletion deduction is to establish a proper valuation of the property at March 1, 1913, if acquired prior thereto, or at the "discovery" date,[7] if acquired after March 1, 1913, and a "discovery" is claimed, for it is on these respective values that depletion is based, except that if a property was acquired after March 1, 1913, and a "discovery" is not claimed, the depletion deduction is based on cost. For purposes of invested capital, it is sometimes necessary to obtain a valuation at the date the property was paid in, if such value is in excess of the stock issued therefor, as par value of the stock in many cases was only a nominal amount. In the last-mentioned case, if the property was acquired prior to March 1, 1913, depletion for the period prior to March 1, 1913, would be computed on the basis of the value of the property at the date paid in, plus allowable capital additions. Beginning with March 1, 1913, depletion would be computed on the value at that date, which usually includes a large amount of appreciation in value. For instance, an individual may have purchased coal lands in 1908 at $400 per acre and thereafter may have charged off periodically against product such an allowance as would reasonably write off the cost before the tract was exhausted. If the value of the unmined coal appreciated, and it could be demonstrated that on March 1, 1913, the fair value was $800 per acre, subsequent to that date the charge for depletion should be doubled.

When such a condition exists, the proper procedure is to debit the property account and credit an account called "Sur-

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[7] See page 1194.

plus arising from reappraisement of property." The property account, as so valued, will then be the basis of depletion charges. An adjustment should be made to have the account properly reflect the necessary charges to the beginning of the taxable year, and thereafter the annual charges should be accurately calculated. If such an account is created it will be desirable to transfer therefrom, once a year, to the regular surplus account, an amount representing the difference between the aggregate depletion actually charged and the amount which would have been charged on the basis used before revaluation. The chief reason for making such transfer is that the item "invested capital" as defined by the excess profits tax law does not recognize appreciation arising out of revaluations unless a sale takes place, but cash realizations of any part of the profit on assets reappraised are additions to invested capital, commencing with the dates of realization.

In a recent ruling[8] the Treasury held that appreciation accrued prior to March 1, 1913, and realized subsequently, represents "profits earned during the year,"[9] and therefore cannot be included as invested capital in the year in which realized. The theory that such realized appreciation is a profit of the current year also would subject to tax any cash dividends paid from such realized appreciation. These points are fully discussed on pages 718-725.

For a method of separating ledger accounts so that surplus accrued before and after March 1, 1913, will be properly segregated, see page 582.

Regulation. Sections 214 (a) (10) and 234 (a) (9) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. These paragraphs of the statute are not materially different from the corresponding paragraphs of the Revenue Act of 1918. These provisions of the statute . . . . do not apply to or affect the regulations covering invested capital, losses, accounting methods, etc.

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[8] See page 721.
[9] Section 326 (a-3).

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (*a*) the cost of his property if acquired subsequent to March 1, 1913, or (*b*) the value of his property on the basic date, plus subsequent allowable capital additions . . . . but not including land values for purposes other than the extraction of minerals. . . . . (Art. 201.)

The following definitions indicate some of the conditions attending a proper valuation, and make the distinction between the "minerals" which, as shown hereinafter, are valued on one basis and the physical equipment which is usually taken at depreciated cost, plus the value of the land, which in some cases may be available for agriculture. The value of land for other than mineral purposes is not to be recovered through depletion charges.[10]

Definitions.—

Regulation. When used in these articles . . . . covering depletion and depreciation—

Basic date.—

(*a*) The term "basic date" indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto; the date of acquisition in the case of property acquired on or after March 1, 1913; or the date of discovery, or within thirty days thereafter, in the case of discovery.

Fair market value.—

(*b*) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

Mineral property.—

(*c*) A "mineral property" or "property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

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[10] See page 1174.

Mineral deposit.—

(*d*) A "mineral deposit" refers to "minerals only," such as the "ores only" in the case of a mine, to the "oil only" in the case of an oil well, and to the "gas only" in the case of a gas well, and to the "oil and gas" in the case of a well producing both oil and gas. The value of a mineral deposit is its cost; or it is the value of the mineral property, less the value of the plant, equipment, and surface of the land for purposes other than mineral production.

Minerals.—

(*e*) "Minerals" include ores of the metals, coal, oil, gas and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand and gravel, silica, slate, soapstone, soda, sulphur, and talc.

Operating profit.—

(*f*) "Operating profit" is the net income from mineral production before depletion and depreciation are deducted. It is distinct from net income. . . . . (Art. 201.)

Cost when used as basis must be bona fide.—

Regulation. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral right or leasehold was acquired, the owner or lessee will be required to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale, by which the property passed to an owner in fact as well as in form other than the vendor. No fictitious or inflated cost or price will be permitted to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether or not the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof. (Art. 205.)

Valuation of Mines

Since in most cases the depletion deduction will be based on the value at March 1, 1913, or on the "discovery" value claimed for properties acquired thereafter, a discussion of

some of the particular problems involved is pertinent at this point. Comments on the regulations dealing with valuation are made particularly with reference to mines. Special considerations bearing on the valuation of oil and gas wells follow. The regulations dealing with timber are also considered in this chapter.

In the early days of the administration of the 1917 and 1918 laws when the matter of the depletion allowance first became of such vital importance, the Treasury attempted to place a value on mining properties gauged by the value of shares of capital stock[11] at or about the date as of which the valuation for depletion was to be made. These attempts, it is believed, proved so unsatisfactory, that the Treasury, following recognized engineering methods, is applying generally a method based on the present value of anticipated earnings, as stated hereinafter. Some of the bases of valuation have been stated as follows:

Method of valuation.—

REGULATION. (*a*) Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of

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[11] "But we must remember that mines are not staples like the metals they produce and that market quotations upon them are of a different order from quotations on staples. Thus lead in a warehouse is always marketable. It is as good as any other lead. Its price varies between certain limits, of course, but the market value, whatever it is, is always there. But there is no such certitude or permanence about the stock of the mine. Today it may be in high favor; five years from now it may be worth twice as much, or nothing at all, and the quotations bear no definite relation to the price of metal, but are influenced strongly, often decisively by other factors.

"Again, we can never be certain that the valuation of stocks by market quotation represents the same action in all cases. Many properties are not on the market at all. Of those actually before the public, some may be in high esteem, skillfully advertised and distributed among a large number of holders; others may be scarcely noticed, with few holders, few transfers, and the market may be merely nominal. It is conceivable that the highly advertised stock might bring twice the price of the obscure one, even though both have the same actual merit.

"I think these considerations are generally conceded to be convincing reasons for subjecting the valuation of mines to a searching and independent review every time such property becomes the object of any important transaction." (J. R. Finlay, *Cost of Mining*, 1920 edition, page 44.)

the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital-stock tax,[12] valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight: (1) If the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer, or to extrinsic causes other than the possession of the mineral itself. Where the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method. . . . . (Art. 206.)

The difficulty is that most profitable mining properties have not changed hands since March 1, 1913.[13] In a considerable number of oil properties valuation must be made after that date, where there has been no change of ownership, but a "discovery" value is claimed. Actual sales are often not a criterion. The author knows of a mine which was sold recently at a price very much above what similar properties in the same district had sold for. The purchaser, however, basing his action on a different operating policy than was used in the district, and on more intensive exploration work, be-

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[12] The connection of the capital stock tax law with fair values of minerals on March 1, 1913, is remote, to say the least, in view of the fact that the first report under the capital stock tax law was not due until 1917.

[13] L. C. Graton, *Federal Taxation of Mines*, page 29.

lieved the property worth considerably more than the price at which similar properties had changed hands, and backed up his belief by purchase.

The ordinary methods of determining values by comparing sales of similar property have been fully discussed in Chapter XVII. The insufficiency of such methods in valuing natural resources is well expressed by an eminent authority:[14]

> It is a matter of common knowledge that in the case of mines and oil and gas wells, and to some extent as to timber, many of the ordinary evidences of value are not good criteria, as properties are not similar and the value of one does not indicate the value of its neighbor. Of two adjacent mines one may be worth millions and the other be a liability; of two adjacent wells, one may be a gusher and the other dry; one timber lot may be first growth pine, and the adjoining one second growth hardwood.

The attempt is made to fix the actual sale value of a coal property by examining the price at which other property similar to that under consideration is sold. This method is derived from existing methods of real estate valuation and, from an engineer's point of view, is acceptable only when checked or supplemented by a valuation on some other basis. Such checks may demonstrate that recent sales were not made at the actual value of the properties sold.[15]

In the case of coal lands where the value has been based on the results of sales of neighboring properties, it will be advisable to have such valuations supported by other methods of valuation.

Present value method.—

FACTORS TO BE CONSIDERED.—In arriving at the value of a property by the present value method, it has been stated[16] that: "The general principle at the root of the matter is that the annual dividends must yield a good annual interest on the sum invested, and also permit a certain sum to be set

[14] R. V. Norris, *The Taxation of Income from Wasting Assets.*
[15] C. E. Grunsky, *Valuation, Depreciation and the Rate Base*, page 230.
[16] J. R. Finlay, *Cost of Mining* (1920 edition), page 29.

aside each year, which securely invested at compound interest, will repay the investment when dividends cease on the exhaustion of the mine."

Regulation. . . . . (*b*) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors are (1) the total quantity of mineral in terms of the principal or customary unit (or units) paid for in the mineral product marketed, (2) the average quality or grade of the mineral reserves, (3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, i.e., cost of production exclusive of depreciation and depletion, and (6) the rate of interest commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, costs of production, and selling price of the product marketed during the expected operating life of the mineral deposit. . . . . (Art. 206.)

The natural resources subdivision claims that the present value of anticipated earnings is being used for very few coal valuations at the present time, that acre values (based on sales) and royalties are being generally used in computing depletion for coal mines.

The present value method has been the subject of the following comment:[17]

As the fair value of a property at any date is the present value of the future earnings discounted to that date, depletion could logically be taken as a percentage of earnings for each year, such percentage being the present value of an annuity of $1 per year for the estimated life of the property, divided by the number of years estimated life. This would return the actual value of the property as of the basic date, as the actual earnings year by year instead of the estimated earnings would be used in the calculations of value.

The maximum life should be limited to 45 years, and interest rates fixed for the different industries.[18]

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[17] R. V. Norris, *The Taxation of Income from Wasting Assets.*

[18] Oil and gas wells in the United States rarely show a maximum life of more than twenty years.

This leaves only the probable life as a factor to be determined and errors in that would not be serious, as when 100 per cent depletion had been paid the deduction for depletion should cease.

Bearing directly on this point are the following conclusions of the American Institute of Mining and Metallurgical Engineers Mines Taxation Committee:

A proper value of a mining property is the present value of the prospective net earnings taking into account probable variations in output and value, discounted by recognized sinking fund methods at a fair rate of interest with sinking fund at 4 per cent interest, or by calculations by standard annuity methods. But other recognized methods of valuation acceptable to the Department may be used.

In lieu of estimated net earnings, where mining on a royalty basis is customary, royalty prices may be used in valuation, taking into consideration the trend of such prices.

As taxpayers, engineers and accountants, during the past year, have had more definite and practical experience in the application of the so-called present value method described above, a question has arisen as to the propriety of the 4 per cent sinking fund requirement. The provision for such a sinking fund in the discount rate results in a lower present value of the anticipated profits and hence a lower depletion deduction. As stated by one of the foremost authorities:

In the practical conduct of mines or mining companies, sinking funds for amortization of capital are never established. In the vast majority of mines of the class under discussion, the ultimate duration of life is unknown, and therefore there is no basis upon which to formulate such a definite financial policy even were it desired. Were it possible to arrive at the annual sum to be set aside, the stockholders of the mining type would prefer to do their own reinvestment.[19]

Furthermore, the introduction of the sinking fund feature really increases the rate of return on the capital invested. The rate of interest is discussed later on in this chapter, but at this point, in considering the validity of the sinking fund, it is pertinent to quote the following illuminating explanation:[20]

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[19] H. C. Hoover, *Principles of Mining,* page 44.
[20] L. C. Graton, *Federal Taxation of Mines,* page 33.

Let us assume that our prospective buyer concludes in a given case under consideration, that he should have 10 per cent on his money each year, in addition to a depletion installment calculated eventually to return his capital sum. As a matter of fact, regardless of whether he spends it outright or invests it in something else or places it, as theoretically intended, in a sinking fund for the positive redemption of capital, his annual depletion installment, if actually received, continually reduces his stake remaining invested in the risky mining enterprise; yet if everything goes well and his original assumptions on the basis of which the valuation was reached prove to be justified, he will be receiving a 10 per cent return on his entire initial capital through the last year when only a small fraction of that capital is invested in the 10 per cent risk and the major part has been used in some other way. In reality, therefore, he received on the average distinctly more than 10 per cent on the capital that is at risk.

The elimination, therefore, of the sinking fund requirement would remedy the situation, for the problem then would be the simple one of finding the present value of an annuity. The proposition of thus providing for return of capital, without a theoretical sinking fund, has been stated as follows:[21]

One way is shown by the following table in which a sum of money is returned to an investor in equal installments, which are supposed to be part interest and part principal. The part that represents the return of principal each year is deducted from the original sum, and for the next year interest is calculated only on the diminished principal; but, since the yearly installments are equal, as the yearly interest requirements diminish, the part applying to the return of principal will increase so that the extinction of capital becomes progressively more and more rapid.

It seems clear from the following amortization table that if the Treasury retains the sinking fund requirment, above discussed, and thus reduces the taxpayer's value for depletion, it must be more liberal in its allowance of interest rates used to represent the expected rate of earning or return on the investment. This question is discussed later in this chapter.

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[21] J. F. Finlay, *Cost of Mining*, page 66. For a discussion as to the decreasing net investment in a mine, see R. H. Montgomery, *Auditing, Theory and Practice* (3rd edition 1921), page 211.

AMORTIZATION TABLE—5 PER CENT

Showing number of years in which $1,000 is returned at 5 per cent if annual recovery is $100 and return of 5 per cent is allowed for an actual investment remaining at beginning of each year.

Years	Amortized	Interest	Balances
Initial investment			$1,000.00*
1	$50.00	$50.00	950.00
2	52.50	47.50	897.50
3	55.12	44.88	842.38
4	57.88	42.12	784.50
5	60.77	39.23	723.73
6	63.81	36.19	659.92
7	67.00	33.00	592.92
8	70.35	29.65	522.57
9	73.87	26.13	448.70
10	77.56	22.44	371.14
11	81.44	18.56	289.70
12	85.51	14.49	204.19
13	89.79	10.21	114.40
14	94.28	5.72	20.12
15	98.99	1.01	.....

*The exact present value of $100 per annum for fifteen years at 5 per cent is $1,037.96. The present value of $100 per annum computed on the basis of an annual return of 5 per cent, with reinvestment earnings of 4 per cent per annum, is only $1,000.58.

WHEN FACTORS ARE UNCERTAIN.—

REGULATION. . . . . (*c*) Mineral deposits for which these factors may not be determined with reasonable accuracy from past operating experience may, with the approval of the Commissioner, be valued in a similar manner; but the factors must be deduced from concurrent evidence such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits in the property itself, the intensity of mineralization, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the property, and other evidence tending to establish a reasonable estimate of the required factors. . . . . (Art. 206.)

It is recognized that in many cases the factors ideally necessary for a scientific application of the present value method will not be found. In such instances it may become necessary to consider the operating history of the property after March 1, 1913, to determine average assays, gross values, costs, production, etc. These can be checked with the operating results obtained by other mines in the district. It is well to supple-

ment such data with comprehensive maps, showing the geology and workings.

There readily comes to mind the case of many ore deposits in limestone where, because of the commonly irregular distribution of the orebodies and the heavy character of the ground when the altered rock is exposed to the air, it is customary to carry development work not far ahead of current extraction. In the matter of valuation on the basis of exposed or proved ore such mines are clearly at a disadvantage with extensively developed mines like the porphyry coppers.[22]

METHOD OF DETERMINING FACTORS.—

REGULATION. . . . . (*d*) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property shall be valued separately. The mineral content of a deposit shall be determined in accordance with article 208. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or definitely adopted at the basic date for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions as defined in article 222, and deductions for depreciation and depletion, but including cost of repairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency. This cost of repairs and replacements is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods. . . . . (Art. 206.)

The foregoing regulation indicates some of the practical problems encountered. If the deposits vary considerably as to grade, it would be manifestly unfair to the taxpayer to allow only a rate of depletion based on high and low grade ores,

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[22] L. C. Graton, *Federal Taxation of Mines*, page 28.

when the high grade only is being mined. On the other hand, in a case where the assays were high at March 1, 1913, but in later years declined, the Treasury does not confine itself to what was known at March 1, 1913, but has been known to take the average of a period of years thereafter which was supposed to be representative. Care must be taken, however, to see that the period selected is really representative and not prejudicial to the taxpayer.

The life of the mine affects the value through the discount factor applied—a long life giving a low value, and a short life a high value. Some of the factors which would determine the life are indicated in the regulation and require detailed evidence to support them. An operating program as at the date of valuation, even if not fully carried out subsequently, would be admissible.

Intensive production means that the units of mineral will be taken out sooner, and as appears from the table on page 1181, the annual income in the earlier years contains a greater element of profit, and thus affords the basis for an increased value of the mine. The earlier the mineral is removed and converted into cash, the less is the amount of discount that needs to be deducted from the expected gross realization to reduce to present value at March 1, 1913.

The costs need particularly to be analyzed and any abnormal items not indicative of probable future costs excluded.

The selling price of the product averaged over a period of years, in order to obtain a normal price, must be considered. Variations in the price, particularly under abnormal conditions, such as have affected silver under the Pittman Act, and copper during the past year with a very great decrease in production, must be fully weighed.

DETERMINATION OF QUANTITY OF ORE IN MINE.[23]—

REGULATION. Every taxpayer claiming a deduction for depletion for a given year will be required to estimate or determine with respect

[23] For former procedure and comments thereon, see *Income Tax Procedure*, 1919, pages 598-602, 1158-1160 (Supp.).

to each separate property the total units (acres, tons, pounds, ounces, or other measure) of mineral products reasonably known or on good evidence believed to have existed in the ground on the basic date, according to the method current in the industry and in the light of the most accurate and reliable information obtainable. Preference shall be given in the selection of a unit of estimate to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion shall include as to both quantity and grade (*a*) the ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms in respect to the type of the deposit, and (*b*) "probable" or "prospective" ores and minerals (in the corresponding sense); that is, ores and minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development; but "probable" or "prospective" ores and minerals may be computed, for purposes of this valuation, (*c*) as to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological or other evidence to a high degree of probability, and (*d*) as to grade, of such richness only as accords with the best indications available. If information subsequently obtained clearly shows the estimate to have been materially erroneous, it may be revised with the approval of the Commissoner. (Art. 208.)

In the foregoing instructions it is provided that the estimate must include minerals "assured" and may include prospective or probable quantities. In making this estimate due consideration should be given to the comments on pages 1231 to 1233. In some cases estimates of possible future extraction have been so large (thus extending the prospective removal over an excessively long period) as to make the annual depletion allowance a negligible factor. Such a result proves the inaccuracy of the estimate, as purchases of mines are not made on such a basis.

The substance of article 208 has been the subject of comment as follows:[24]

Quantities are required to be estimated as of March 1, 1913. In making such an estimate any engineer would make his estimate up to the date of examination, and reduce to the basic date by adding the units produced between the basic date and the date of examination.

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[24] R. V. Norris, *The Taxation of Income from Wasting Assets.*

While perhaps technically no information not available March 1, 1913, is supposed to be used in such estimates, in this case, as in the case of estimating profits, no engineer would or should be asked to stultify himself by using estimates based on what he may try to imagine he would have thought on March 1, 1913, but which on information available when his estimate was actually made he knows to be incorrect. The Department has repeatedly and very sensibly accepted estimates frankly made in this way.

The necessity for a revision of original estimates is shown in the following:

Ruling. . . . . During the year 1917 in the development of the mining operations of the taxpayer, it was discovered that the company's coal vein was lacking in approximately z acres and that there was hard black rock in its place. This so-called "rock fault" was actually determined by tests and statements to this effect are supported by affidavit of engineers. On the basis of original cost of this vein of coal, the development of this large area of solid rock determined a loss of x dollars. With respect to loss of this character, section 234(a) of the Revenue Act of 1918 does not materially differ from section 12(a)2 of the Revenue Act of 1917.

The examining revenue agent reports that the vein of coal purchased had an estimated recovery of y tons per acre. In the original acreage purchased there were $4z$ acres. The acreage loss by location of the rock fault was z acres, leaving actual coal acreage purchased $3z$ acres. The en bloc tonnage on revised estimate was, therefore, $63y$ tons which, at a cost of $3x$ dollars, gives the cost per unit for depletion charge on basis of $3z$ acres actually contained in this tract.

It is contended by taxpayer that a loss of x dollars has been established during the year 1917 under article 143 of Regulations 45. The amount of alleged loss is based on cost at $1/25x$ dollars per acre plus four years' interest charges.

The Committee can not reach the conclusion that location of this rock fault determines a loss of useful value as contemplated by the regulations. The rock fault determined that a bad estimate had been made in fixing the consideration of purchase. This mistaken value for tax purposes affected the true measure of capital returnable by way of depletion. Article 208, Regulations 45, provides for the determination of mineral contents of a mine. The last sentence of the article reads:

> If subsequent developments show a material error in the original estimate, a new estimate may be made and the capital remaining to be recovered distributed accordingly.

Hence, if this mine was under production after discovery of the rock fault, the capital remaining to be recovered through depletion

may be distributed pro rata over subsequent years. If the mining operation of this property was discontinued entirely in the taxable year, the deduction for depletion should be taken in that year so that the return of capital may be complete. No interest on the capital sum should be considered in this computation.

If an erroneous estimate is made and a large amount of tax is paid in the years of high rates (1917 to 1921) and the error is discovered in 1922, it would be equitable to permit the filing of amended returns on the basis of a correct estimate.[25]

Calculation of Value.—

Regulation. . . . . (*e*) The number of units of mineral recoverable in marketable form multiplied by the difference between the selling price and the operating cost per unit gives the total expected operating profit. The value of each mineral deposit is then the total expected operating profit from that deposit reduced to a present value as of the basic date at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at the basic date of the depreciable assets and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral property prior to the basic date; relatively higher risks attach to appraisals upon any other basis. (Art. 206.)

If the mine at date of valuation is not equipped, it is customary to discount further the operating profits, on a straight compound interest basis, for the number of years necessary to equip the mine. For example, if two years are necessary to equip the property, the value of the ore is still less, because of the further loss of interest in delay.[26]

The following expression of opinion as to the best method of determining fair market value is also of interest:

The valuation engineers of the Revenue Bureau, as I understand it, are to answer the question of valuation that is comprehended in the imaginary situation of a prospective buyer, competent to measure mine values and actuated by the hope of profit to be derived from mine operation, making an offer for a mine to the owner who is likewise competent to measure mine values and who is under

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[25] See page 601.

[26] H. C. Hoover, *Principles of Mining*, page 48.

no obligation to sell except such obligation as arises from his belief that the offer made is advantageous to him. . . .

In arriving at fair market value as of March 1, 1913, one is supposed to take into consideration only the facts that were then known or that could have been then known had one endeavored to learn them at that time. The question may therefore arise as to whether it is fair to arrive at a 1913 valuation by applying to the standard present-value method of mine valuation modifications which have not been proposed until 1919. In my opinion, however, there is sufficient justification for using those modifications that are consequences of taking into account changing grade of ore and changing rate of production. The justification is this: In 1913 and since that time there was no *actual* method followed for valuing mines for purpose of sale, for the reason that mines of the size to which these newly proposed factors would apply are rarely, if ever, sold. In arriving at a market value as of 1913, therefore, we are dealing with a wholly hypothetical question. *If* there had been occasion to value such mines for sale in 1913, it is unbelievable that factors so important as the change in grade of ore and the likely change in rate of production would have been ignored. In other words, if a market value had been required at that time, it would have been reached in accordance with the methods now proposed.[27]

WHAT IS FAIR RATE OF INTEREST?—There seems to be considerable difference of opinion as to what is the proper rate of interest to be used in determining the present value of future earnings, when arriving at the value of mining property as at a specified date.

It is understood that the Treasury is using 8 per cent for bituminous and 6 per cent for anthracite coal properties. An eminent authority[28] points out that rates vary considerably with the risks involved and summarizes the various rates that have been used by other authorities, as follows:

The proper rate of interest on mining investments has been and still remains the subject of much discussion among engineers. A reasonable solution of the problem has not been advanced and it is the belief of the author that it is not possible to determine a rate of interest that would apply equally well to all mining investments. The risk incurred by investing in a property that has been slightly developed is much greater than the risk in the case of a well-prospected ore body even when the mines contain similar ores and will be operated

[27] L. C. Graton, *Federal Taxation of Mines.*
[28] C. E. Grunsky, *Valuation, Depreciation and the Rate-Base,* page 241.

under similar conditions. Then again the average risks in copper mining differ from the average risks in gold mining and so on.

Mr. H. C. Hoover has tabulated the risks of mining as follows (*Principles of Mining,* 1909):

"1. The risk of continuity in metal contents beyond the sample faces.
2. The risk of continuity in volume through the blocks estimated.
3. The risk of successful metallurgical treatment.
4. The risk of metal prices, in all but gold.
5. The risk of properly estimating costs.
6. The risk of extension of the ore beyond exposures.
7. The risk of management."

Several of these risks are found in industrial enterprises (risks 4, 5 and 7). The risks of continuity of ore body and of ore values are peculiar to the mining industry. The limited market for the mineral products and the effect of the volume of the output on the prices that can be obtained increases the risk that capital must take. The problem of obtaining proper metallurgical treatment is an important one, particularly when starting operations at new properties. The fact that the mineral constituents of the ore may change as greater depths are reached and that the previously satisfactory flow sheet may no longer realize the percentage of extraction on which the profits were based cannot be ignored by the investor. The interest return that might be attractive to an investor in a proven district might not be sufficient to attract capital in a district where the mines are still prospects and where the depth of the mineralization has not been tested.

It is a fact that industrial enterprises because of additional risks demand greater interest returns than government bonds and it seems reasonable that mining investments taken as a class should call for a greater rate of interest than industrial enterprises.

This claim for a higher rate of interest is opposed by such an authority on mine valuation as Mr. J. R. Finlay (*Valuation of Iron Mines,* Trans. A. I. M. E., Volume 45, page 295), who can be quoted, as follows:

"I have generally assumed that 5 per cent was a normal interest —or discount rate. If that is so, it is a fair figure to use in a mine valuation, which should be nothing but a candid inquiry into the present value of expected profits."

If Mr. Finlay's statement is correctly understood, he is willing to ignore the risk that these prospective profits may be diminished or may entirely be cut off before the estimated life of the property has been accomplished. If it is true that at any mining property risks exist over and above the risks existing in so-called "safe" investments, then a 5 per cent discount or interest rate is not sufficient to induce

sane investment. Mr. Finlay's 5 per cent interest rate, as applied to the iron mines of Michigan in his appraisal made for the State Tax Commission in 1911, was changed by that Commission to a 6 per cent basis in 1913.

Other authorities have gone on record as advocating higher interest rates and in this connection the following will be found of interest:

Mr. J. H. Curle (*The Economist*, London, September 15, 1903) states that a suitable mining investment must fulfil the following requirements:

"1. The development in the bottom must be good.
2. The mine must pay 10 per cent per annum.
3. There must be 60 per cent of the price of the shares in sight."

Mr. Hoover in his admirable work on mine valuation says (*Principles of Mining*, 1909):

"What rate of excess return the mine must yield is a matter of the risks in the venture and the demand of the investor. Mining business is one where 7 per cent above provision for capital return is an absolute minimum demanded by the risks inherent in mines, even where the profit in sight gives warranty to the return of capital."

Mr. G. A. Denny (*Mexican Mining Journal*, July, 1910), an English engineer, says:

"A normal mining risk stated in terms of interest may be taken at 10 per cent per annum on the capital expended plus a rate for the redemption of capital."

John Hays Hammond (*Engineering and Mining Journal*, January 1, 1910) expresses his views on this question as follows:

"In many mines persistency of the ore deposits and, therefore, the reliability of the mines as dividend payers, justified the investment upon a basis in some instances as low as 8 per cent, dividends to which of course, must be added a certain percentage to provide for the amortization of the capital. Generally speaking, however, investments in mining securities are not to be regarded as attractive unless they return from 10 per cent to 15 per cent in dividends, in addition to the profits to be set aside for amortization."

The Treasury has, in some instances, adopted a higher rate of interest than taxpayers have felt to be warranted. It is noteworthy that an eminent authority in his latest work still maintains that 5 per cent is sufficiently high.[29]

The author is of the opinion that it is impossible to fix a

[29] J. R. Finlay, *Cost of Mining* (1920 edition), page 66.

rate of discount for an industry which should be applied to all taxpayers in the same industry. Each case should be treated separately, and the rate fixed in accordance with the risks involved.

In the case of a lessor the contention was advanced by a certain taxpayer that 6 per cent is an equitable rate because the risk is reduced to a minimum on account of a clause in the lease which provides that in case of the failure of the lessee to pay the royalties all rights under the lease will be forfeited together with all improvements made by the lessee.

Since the risk to the lessor is never as great as that to the lessee, the rate of discount should be somewhat lower than that used for determining the value to the lessee.

It must be remembered that the Treasury, in discounting the anticipated profits, uses a formula which provides for interest on the principal sum at one rate, say 10 per cent, and also provides for an annual contribution to a sinking fund, which, accumulated at 4 per cent interest compounded annually, will equal the principal sum at the end of the term. The actual return on the capital sum, however, is greater than 10 per cent due to the introduction of the sinking fund provision.[30] The increase in interest rate has been worked out as follows:

On the assumption that money in an ordinary, good investment is entitled to 6 per cent, it is found that in the case of a property of 10 year life, valued to give 10 per cent on initial sum and amortized at 4 per cent compounded annually, the ratio of total profit assignable to amount remaining at risk in the property, divided by the total of the amounts at risk during each of the 10 years, works out to be not 10 per cent but 13.25 per cent. Similarly, for a 10 year life, an apparent 8 per cent return is found to give an average of 9.71 per cent; and a 12 per cent return to average in reality 16.79 per cent on the money at risk. In the three cases, 8 per cent, 10 per cent, and 12 per cent, these actual average returns are respectively 21.4 per cent, 32.5 per cent, and 40 per cent higher than the flat rate to which they are related.

The question now arises whether this greater interest return, concealed in the apparent flat rate of 10 per cent, is actually required

[30] See page 1177.

to offset hazard, or whether on the other hand, an even 10 per cent on the decreasing sum actually at risk is enough, in which case the present value of the mine would increase.[31]

Attention has already been called (page 1179) to the fact stated by one of the most eminent authorities, Mr. Herbert C. Hoover, that sinking funds for the reinvestment in conservative securities of the annual depletion allowances are in the practical conduct of mines and mining companies never established. The Treasury in using the present value of anticipated earnings for determining the value of oil and gas wells[32] does not use the 4 per cent reinvestment factor which it insists shall be used in valuing mines. The author knows of no reason why mines should be thus discriminated against.

Since the depletion deductions return to the mine owner annually a part of his capital, leaving a decreasing sum at risk, it would seem to be sufficient to require interest i.e., a return each year, only on the decreasing sum and not on the entire capital originally invested.

Illustration of present value method.—An illustration showing the computation of the value of a mine as of March 1, 1913, appears on pages 601.

The computations will be varied by whatever necessities arise which require treatment of the various factors employed in a manner to reflect properly normal conditions and the elimination of abnormal items.

Evidence required to support depletion charges.—The law permits a reasonable allowance for depletion and no more. It is proper and necessary that taxpayers should comply with all reasonable Treasury requirements and furnish detailed evidence bearing on the propriety of the deductions claimed.

In addition to the regulations reproduced in full in this

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[31] L. C. Graton, *Federal Taxation of Mines*, page 33.

[32] The *Manual for the Oil and Gas Industry*, published by the Treasury Department, contains on page 57, a discount table for computing present values. This table includes no reinvestment feature.

book, the Treasury has prepared comprehensive "schedules of depletion."[23] The information which taxpayers are required to submit in these schedules or questionnaires includes maps of the property; full particulars of contents and production at March 1, 1913, and subsequently; kinds of ore or mineral produced; manner of acquisition and, when cash was not paid for property, cash value of securities issued; details of appraisals, if any; details of sales of similar properties; estimates of deposits made by engineers or others; assessments for local taxation; sales of securities on exchanges or at private sale; partnership or estate accountings, if any, about March 1, 1913; various other details are required, all of which are pertinent and proper.

It should be noted, however, that the so-called market value of the securities of a corporation frequently is not a true indication of the fair market value of any particular asset. The courts have so decided many times.

It is understood, however, that the Treasury is most reasonable and does not require or expect special research to answer these questionnaires. Information not affecting the taxpayer's claims is not needed and blanks for this may be ignored.

Revaluation after March 1, 1913, not permitted except in case of discoveries.—At the time the value is being determined, it is important to present all the pertinent data to the Treasury in order to secure the maximum valuation to which the taxpayer is entitled, because after the value is once determined, the regulations provide that a revaluation will not be permitted. It must be remembered that the depletion allowance for all subsequent years is based on such valuation.

It is well settled practice (although disputed by many persons) that appreciation since March 1, 1913, cannot be considered in increasing depletion allowances or reducing the

[23] Form D (minerals), form E (coal), form F (miscellaneous nonmetals), form O (oil and gas), form T (timber).

taxable profit arising from sales, except in the case of discoveries.[34]

Regulation. No revaluation of a property whose value as of the basic date has been determined and approved will be allowed during the continuance of the ownership under which the value was so determined and approved except in the case of discovery as defined in articles 219 and 220 or of misrepresentation or fraud or gross error as to any facts determinable on the basic date. Revaluation on account of misrepresentation or fraud or such gross error will only be made upon written application to the Commissioner and approval thereof by him. The value as of the basic date may, however, be corrected when a virtual change of ownership of part of the property results as the outcome of litigation, and may be redistributed (*a*) when a revision of the number of units of mineral in the property has been made in accordance with articles 208, 209, or 211, and (*b*) in case of the sale of a part of the property, between the part sold and part retained. (Art. 207.)

In a case where the "probable or prospective" ores had not been included in the original valuation, a revaluation was permitted, as shown by the following:

Ruling. While article 207 does not permit of a revaluation of property whose value as of the basic date has been determined, it is clear that only a valuation based upon an estimate of the recoverable units including not only ores and minerals in sight, blocked out, developed or assured, but also probable or prospective ores, is contemplated by this article. The meaning of this article is that once the property has been valued in accordance with the Regulations as they now stand, it can not be revalued because it subsequently develops that the taxpayer has in his mine more ore than could reasonably have been included in the original estimate of recoverable units when the estimate was properly made.

If, as is now contended by the M Company the original valuations were based upon estimates of recoverable units which included only ores in sight, blocked out, developed or assured, the properties should be revalued as of the basic date in accordance with the present regulations and the rate of depletion determined accordingly. If it should subsequently develop that a material error in the original estimate of the recoverable units was made, the properties may not be revalued but a redistribution of the depletion may then be made as provided in articles 207 and 208.[35] (Extract from memorandum of the Solicitor; C. B. 4, page 190; A. R. M. 124.)

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[34] See page 1196.
[35] See page 1184.

The Treasury does not have the power to foreclose a taxpayer's right to review in case of error, except in cases when the right to claim a refund for prior years is barred by statute.

Discovery of mines.[36]—

Fair market value disproportionate to cost.—

Regulation. (*a*) The discovery must add a new mine to those previously known to exist and can not be made within a proven tract or lease as defined in paragraph (g) infra. (*b*) To entitle a taxpayer to a valuation of his property, for the purpose of depletion allowances, by reason of the discovery of a mine on or after March 1, 1913, the discovery must be made by the taxpayer after that date, and must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the newly discovered mine contains mineral in such quantity and of such quality as to afford a reasonable expectation of return to the taxpayer of an amount materially in excess of the capital expended in making such discovery plus the cost of future development, equipment, and exploitation.

Definition of discovery.—

(*c*) For the purpose of these sections of the Act a mine may be said to be discovered when (1) there is found a natural deposit of mineral, or (2) there is disclosed by drilling or exploration, conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been, included in any previous valuation for the purpose of depletion, and which in either case exists in quantity and grade sufficient to justify commercial exploitation.

(*d*) In determining whether a discovery entitling the taxpayer to a valuation has been made, the Commissioner will take into account the peculiar conditions of each case; but no discovery, for the purposes of valuation, can be allowed, as to ores or minerals, such as extensions of known ore bodies, that have been or should have been included in "probable" or "prospective" ore or mineral,[37] or in any other way comprehended in a prior valuation, nor as of a date subsequent to that when, in fact, discovery was evident, when delay by the taxpayer in making claim therefor has resulted or will result in excessive allowances for depletion. . . . . (Art. 219.)

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[36] For discovery of oil and gas wells, see page 1205.

[37] See page 1184.

When improvements in processes of treatment make valuable certain ores previously of no value the Treasury recognizes that exploration for such ores will be stimulated, hence "discovery" is made; but it is unwilling to allow a discovery value of the same kind of ores known to exist in the mine before the improvement in process made the ores valuable.

Ruling. Advice is requested as to whether certain known bodies of zinc and copper ores owned by the M Company could be revalued on account of improvements in certain metallurgical processes which made valuable ores which theretofore had no commercial value.

This inquiry raised a point of law and inasmuch as the amendment of the regulations with respect to discovery was under consideration the matter was referred to the Solicitor for consideration and an opinion. The Committee is in receipt of a memorandum from the Solicitor dated March 9, 1921, which reads, in part, as follows:

As the question is presented in the memorandum the claims of discoveries in the case of zinc ore were based upon improvements in metallurgical processes, making valuable ores which had theretofore had no commercial value. It now appears that, while these processes first made commercially valuable zinc ores which before that time were valueless, by reason of this very fact the indications of zinc ore which had originally been found in these mines, were not followed up, and the presence of the zinc ores which were commercially valuable by any process of treatment was not actually discovered until the dates claimed for discoveries. The claims for discoveries in the case of zinc ores, therefore, have no different basis than the claims for discovery of copper ores.

At the time this memorandum was received in this office, regulations dealing with the question of discovery were in process of preparation, and it was not deemed advisable to anticipate those regulations. The regulations have now been prepared and appear as articles under the appropriate heading, in Regulations 45 (1920 edition).

Articles 219, 207, and 208 of these Regulations appear to answer the question presented.

Under this article[38] a discovery for the purpose of a new valuation for depletion can not be made in a "known mine," nor can a discovery be made of any "probable" or "prospective" ores which had been or could have been included in the previous valuation. This appears to exclude most, if not all, of the alleged discoveries of copper ores. It will be noted that this article does not recognize a discovery for the purpose of depletion as the result of improved processes of treatment of ores, making commercially valuable ores which were theretofore valueless. This omission was intentional and made only

[38] Referring to Art. 219 (b) and (f).

after mature consideration. If, however, bodies of zinc ore, not theretofore known to exist, were discovered within the meaning of the Regulations, the fact that the explorations were stimulated by recent improvements in metallurgy which made them commercially valuable for the first time would not bar a claim for discovery. . . . . (C. B. 4, page 190; A. R. M. 124.)

The foregoing definition of the word "discovery" may not be upheld by the courts. If a purchaser of low grade ore finds a body of high grade ore, surely it is a discovery. It may be, however, that the term will be strictly interpreted in view of the intention of Congress to extend what may be characterized as a tax privilege.

Value 30 days after "discovery" must be reasonably certain.[39]—

Regulation. . . . . (*e*) The value of the property claimed as a result of a discovery must be the fair market value, as defined in article 206, based on what is evident within thirty days after the commercially valuable character and extent of the discovered deposits of ore or mineral have with reasonable certainty been established, determined or proved.

Capital account to be adjusted.—

(*f*) After a *bona fide* discovery the taxpayer shall adjust his capital and depletion accounts in accordance with article 206, 208, and 210, and shall submit such evidence as to establish his right to a revaluation, covering the conditions and circumstances of the discovery and the size, character, and location of the discovered deposit of mineral, the value of the property at the prior basic date, the cost of discovery, and its development, equipment, and exploitation, its value and the particular method used in the determination.

Proven tract or lease.—

(*g*) In the case of a mine, a "proven tract or lease" includes, but is not necessarily limited to, the mineral deposits known to exist in any known mine at the date as of which such mine was valued for purposes of depletion, and all extensions thereof, including "probable" and "prospective" ores considered as a factor in the determination of the value or cost. (Art. 219.)

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[39] See page 1205.

Valuation of Oil and Gas Wells[40]

In the foregoing pages dealing with the valuation of mines, the general principles underlying the valuation of mineral properties for purposes of depletion have been explained. The following discussion refers to some of the particular problems found in the valuation of oil and gas wells.

In view of the highly technical regulations relative to the gas and oil industries the Treasury has prepared an exhaustive treatise which should be consulted by all interested.[41] Therefore articles 209, 211-214, 220, 220 (a), 223 and 226 are omitted from this chapter.

Among petroleum engineers the recognized method of appraising an oil or gas property for tax purposes is on the basis of past production of similar properties in the same sand and pool or geographical district. The authority for this method is the law of equal expectations, which is as follows: "If two wells under similar conditions produce equal amounts during any given year, the amounts they will produce thereafter, on the average, will be approximately equal, regardless of their relative ages."[42]

Production decline curves.—The past production of individual wells may be graphically represented by production decline curves which depict the decline in the production of a well over the period of its existence. Such curves are constructed on co-ordinate paper with evenly spaced divisions, the vertical scale indicating units of production, the horizontal scale representing years. The curve for an oil well is symmetrical. The decline of production in the first year of the well's existence is very rapid but the slope gradually subsides until it approaches the horizontal. All oil curves are of this type. Wells

[40] For former procedure and comments thereon, see *Income Tax Procedure*, 1919, pages 602-609, 1156-1164 (Supp.).

[41] The book contains 245 pages and is entitled *Manual for the Oil and Gas Industry*. Copies may be obtained from the Superintendent of Documents, Washington, D. C., for 25 cents each.

[42] *Manual for the Oil and Gas Industry* (1921), page 73; and *Bureau of Mines Bulletin* 177, by Carl H. Beal (1919), page 36.

with a large first year production decline more rapidly than wells with a small initial production. The curve for a gas well approximates that of an oil curve, but it is less likely to be symmetrical.

The unit of production in the case of oil is the barrel. There is little difficulty in obtaining the records of the production for this unit as the production of a lease is generally measured on the lease by the flow of oil into tanks. Royalties, the equivalent of rents, on oil leases are almost universally based on production, the lessor usually receiving the value of one-eighth of the production.

There is a different situation with gas. The production unit is a thousand cubic feet. Royalties consist of fixed payments each year or payments based on pressures taken at the well. There are numerous instances where producers do not meter their gas at the lease and it is not metered until it reaches the consumer. This is not fatal if the producer has accurate pressure records from which the production of a well for the year may be calculated. Where there are not accurate pressure records the appraiser should check his estimate of production in the field by adding to the total volume of metered gas the line losses, or leaks from the pipe lines carrying the gas, and such other losses between the wells and the meters, as free gas to the lessor and gas used by the lessee for drilling purposes.

Line losses are difficult to estimate when the production in the field is not known. They vary according to the weather, condition of the pipe line, and the type of pipe line. Line losses in a city are apt to be large because of the frequent connections made for each house or factory. Welded lines show less loss than other types. Leaks are more frequent in the winter than in the summer. It is obvious that with such difficulties at the outset the estimation of the gas which a well will produce is subject to a large percentage of error.

Having constructed decline curves for the individual wells, the next step is to construct a composite production decline

curve for a given sand in a given pool or district. The *Manual for the Oil and Gas Industry*[43] recommends that the family curve be used. The family curve is constructed by selecting the largest producing well in the pool, and, using that as a basis, putting the production of the second largest well with its first year's production on the curve of the first well, the third in the same way, and so on. An average curve is constructed giving due weight to the variations of each well. There is a considerable personal equation with the consequent danger of error involved in this method. It is laborious and difficult to accomplish neatly. Some engineers have found that the segmental method is a short and fairly accurate method of constructing a composite decline curve. This consists of averaging the periods of time for declines between selected points of production. The months or years required by all the wells to decline from a production of, let us say, 100 to 90, 90 to 80, 80 to 70, etc., are read from the individual well curves and averaged by dividing the total amount of time by the number of producing wells.

Great care must be exercised in selecting the wells to be used in the composite production decline curve. All aberrant or erratic wells such as those which show the effects of water, which are abandoned after short periods, and which are drilled too closely to one another, should be excluded. In making individual curves for gas wells the appraiser should exercise caution in selecting pressures upon which to calculate yearly production. The majority of Appalachian producers who supply domestic consumers shut in some of their wells during the summer months as the demand for gas is low, practically none being required for heating purposes. The effect of shutting in the wells is to increase the pressures. In the winter pressures are low, due to the cold weather and the heavy drain on the fields made necessary to supply the consumers with gas for fuel. In general the pressures at the end of September are

[43] *Manual for Oil and Gas Industry*, page 86.

representative pressures upon which to base a calculation of the year's volume. Abnormally low pressures due to the presence of water in a well or sudden high pressures due to the abandonment of nearby wells should be disregarded.

The composite production decline curve represents the decline in production of the average well in a given sand, or stratum, and geographical district. To obtain the estimated future production of a well, the point on the composite decline curve corresponding to the yearly rate of production as of the date of valuation of the well is located and the future production is read off, year by year, to the economic limit. The economic limit is that point where the production is so small that the producer makes no profit by operating the well. The economic limit varies according to the profit on the commodity. The sum of the future production, year by year, equals the estimated recoverable reserves, or the amount of oil or gas which the taxpayer expects to produce.

Field prices and costs.—Prices are estimated for the oil or gas unit of production on the lease. The taxpayer places a value on his well or lease, taking into consideration the transportation facilities available. It is essential in predicting future prices, especially in the case of oil, that the engineer be acquainted with the supply of and demand for the commodity. In recent years price curves depicting the rise in price of oil since the year 1900 extrapolated, or extended, into the future with the same percentage of increase, have been unsatisfactory because of the sudden drop in the price of oil at the beginning of 1921. This type of prediction has been successful for the prices of gas in the Appalachian region. In this section the gas reserves seem to be steadily declining with no new pools being discovered. One company had one-third less production in 1920 than in 1916, although it had about 30 per cent more wells producing in 1920. The producers are educating the people in methods of conservation and at the same time gradually increasing the prices against

the day when there will be no natural gas resources and the people must use artificial gas, which is more expensive. Some of the cities of Pennsylvania which formerly used natural gas for fuel have had to turn to coal within the last year. This situation indicates that the taxpayer in the Appalachian field is safe in assuming that the price of gas will rise steadily for the next few years.

Where a producer does not sell his gas in the field to a pipe line company, and has only a consumer's price, there is the same difficulty in estimating a field price as there is in estimating field production when there are no pressure records. Field prices must then be estimated by deducting from consumers' prices the value of line losses, free gas, and gas used for drilling or other purposes.

Production costs include the cost of drilling, maintenance, and transmission of the product to the lease boundary. The appraiser should be cautious about estimating his future costs on the basis of the rise in the past because of the inflation of prices of materials during the period of the recent war.

The field price per unit of production minus the production cost in any year, equals the future net revenue for the unit in that year. The future net revenue for the unit for a year times the estimated recoverable units of production for the year, equals the net revenue for the property in the year.

Present value method.—To obtain the present worth of the property discount factors of from 8 to 10 per cent are used.

In addition to the discount to obtain the present value, a "discovery" well should be further discounted for the risk of abandonment, which is the risk that natural forces, such as water, will prevent the actual production equalling the anticipated production, and the risk of offset wells, that is, the risk that rival producers will drill so close as to drain a portion of the resources of the well.

The discount table published by the Treasury[44] is based

[44] *Manual for the Oil and Gas Industry*, page 57.

on the present value of $1 due a number of years hence, the present value being worked out for each year separately. The sum of the present worths for each year is the total value to be ascribed to the property. The necessity for discounting each year's income separately is that production in an oil property progressively declines, whereas in a mine it is assumed to be fairly constant year after year. The discount table contains no reinvestment feature as is the case in the tables used for mines; that is, no provision is made for establishing a theoretical sinking fund at 4 per cent compounded annually, as in the case of mines, which results, of course, in a greater present value being assigned to the property. As stated by the Treasury, "The rate of discount employed depends upon the judgment of the person making the valuation."[45]

Risks affecting rate of return.—Some of the ordinary risks to be considered in valuing oil and gas properties are:

1. For wells valued as of March 1, 1913:
   - (a) Risk of offset wells or the risk that rival producers will drill producing wells so close to the property as to drain a portion of the resources.
   - (b) Risk of abandonment, or the risk that natural forces will prevent the actual production equalling the anticipated production.
2. For discovery wells:
   - (a) Risk of dry holes, or the risk that there will be no production.
   - (b) Risk of abandonment.
   - (c) Risk of offset wells.
3. For undrilled locations:
   - (a) Risk of dry holes.
   - (b) Risk of abandonment.
   - (c) Risk of offset wells.

Manual for the Oil and Gas Industry, page 58.

(d) Risk of deferment in drilling, the risk that the rate of production in the field may be smaller at the time the proposed well is drilled.

Perhaps in 1913 it would have been absurd for engineers to attempt to estimate the present value of oil and gas wells by appraisals. During the last six years many improvements have been made in the methods of valuation so that at the present day with the law of equal expectations[46] and the use of production decline curves as a basis for estimates, very fair values may be placed upon oil and gas properties.

Valuation of undrilled acreage.—A fair method of valuing undrilled acreage surrounding a well is on the basis of the drilling program which any experienced producer would inaugurate. The drainage area of a well varies as to its locality and the porosity of the sand. In the Appalachian field an oil well drains about eight acres and a gas well approximately forty acres. Using the drainage area of the well as a basis, the appraiser indicates on a map the territory which he expects to be drilled, taking into account the geological conditions, the practical difficulties, and the necessity of placing the wells in such positions that they will drain the maximum amount from the taxpayer's territory at the least cost, and at the same time be as near the lease boundaries as possible in order to drain neighboring leases held by rival producers. The value of a location for a future well should be discounted for deferment, the risk of a dry hole, the risk of abandonment, and the risk of offset wells. The risk of deferment is the risk that the rate of production for the field will be smaller than its present rate at the time the proposed well is drilled. The risk of a dry hole is the risk that the proposed well will not produce any gas or oil at all.

Gasoline.—In recent years producers have found that sometimes they can absorb gasoline from the gas as it comes

[46] *Manual for the Oil and Gas Industry* (1921), page 73.

from the well. Where the producer has indicated by the presence of an absorbing plant his intention to take out the gasoline at the date of valuation, or shortly thereafter, he may claim depletion on the gasoline contents of the gas, as well as on the gas itself.

A refiner may have a large number of contracts for the purchase of gasoline at the wells. It is understood that he is allowed to deplete the value of these contracts. Apparently the reason for this is that the refiner has a legal interest in the mineral content of the well similar to that of the lessee who is allowed to claim depletion for the value of his rights. Depletion of such contracts, however, would be permissible only if they were held at March 1, 1913, or were acquired since for a valuable consideration.

Evidence required to support depletion charges.—Although the oil and gas taxpayer reaps many benefits under the income tax law as it now stands, he must also undergo considerable expense in meeting the requirements of form O to support his claims for depletion and depreciation. The information required is not likely to be kept in such form by the taxpayer that he can readily produce it. Some companies require three years, with a staff of twenty men and girls working continuously, to complete amended returns from 1913 to date. Detailed information as to each lease is required. When a taxpayer has three or four thousand leases, this information is in itself a burden. The most unreasonable requirement is that a taxpayer show development in the neighborhood of his discovery. This is in effect compelling him to wrest information from his rivals. Probably the Treasury Department is not particular as to this feature today, as the government maps showing development are understood to be in good shape. In the case of discovery wells the Treasury Department asks for the true bearing and distance of all wells within 3,733.5 feet of the discovery. In thickly drilled fields this is almost impossible of accomplishment. The information as to true bearing

should be eliminated, since the Treasury holds under the law that ordinarily a discovery proves a maximum area of 160 acres.

Revaluation after March 1, 1913, not permitted except in case of discoveries.—The comments on page 1192 apply equally to oil and gas wells. Article 206a is therefore omitted.

Discovery of oil and gas wells.—

Fair market value disproportionate to cost.—In the case of oil and gas properties it is understood that the Treasury Department requires that the fair market value of the property must exceed the cost by at least 100 per cent.

The law,[47] however, does not fix any definite percentage by which the fair market value must exceed the cost. It reads "where the fair market value is *materially* disproportionate to the cost."

Proven tracts in relation to discovery claim.—The Treasury interprets the law allowing revaluation on account of discovery as meaning that a discovery well ordinarily proves an area of 160 acres of a sand regardless of private boundaries, or in other words, a producing well indicates that there is a reasonable certainty that the area of 160 acres around the well contains oil and gas in sufficient quantities to justify its exploitation.[48]

The discovery law was originally enacted to protect the adventurous oil men who drilled wild-cat wells, or who drilled and opened up undeveloped territory. As such producers take large risks their returns should be large. The original interpretation of the law was that a discovery well proved a pool or geographical district. The more recent rulings of the Treasury indicate that a proven area is limited to 160 acres. The following are some of the ordinary cases which arise

[47] Sections 214 (a-10) and 234 (a-9).
[48] *Manual*, page 44, first paragraph.

under the first three paragraphs on page 44 of the *Manual for the Oil and Gas Industry* (1921).

1. The Smith lease is taken in 1916. The Jones No. 1 is drilled in 1918 and produces from the Big Injun sand. The Smith No. 1 is drilled to the Big Injun in 1919 within the area proved by the Jones No. 1. A discovery may be claimed since the Smith lease was acquired before the Jones well was drilled.

2. The Smith lease is taken in 1918 and No. 1 well is drilled to the Big Injun sand in the same year. Although the well itself is not on proven territory it is compactly surrounded by the proven areas of other wells drilled to the Big Injun sand in previous years. No discovery may be claimed. This is a case where the present interpretation of the Treasury contains the spirit of the old interpretation that a well may prove more than 160 acres.

3. The Jones No. 1 is drilled to the Big Injun sand in 1917. The Smith lease is taken in 1918 and the No. 1 well is drilled to the Speechly sand in 1918 within the 160 acres surrounding Jones No. 1. Smith No. 1 may be claimed as a discovery since its production comes from a different sand. The Jones No. 1 proves 160 acres of Big Injun sand but does not prove the Speechly sand.

4. Smith No. 1 is drilled to the Big Injun sand in 1917 and valued as a discovery. In 1918 it is drilled deeper to the Speechly sand. It may be revalued as a discovery in the Speechly sand, since that sand was not proved by the discovery in the Big Injun sand.

5. Smith No. 1 is drilled in undeveloped territory. It produces oil from the Berea sand and gas from the Big Injun. It should be valued as an oil discovery and a gas discovery.

6. Where the Wildcat Oil Company owns the Smith lease but not the Jones lease and part of the proven area of Smith No. 1 lies on the Jones lease, that portion of the acreage may not be valued by the company. Nor may the owner of the Jones lease value it, since he has not made the discovery.

7. The Jones lease lies east of the Smith lease. The Smith No. 1 is a discovery in the Gantz sand. The Smith No. 2 is drilled to the same sand easterly and within the proven area of the Smith No. 1 and proves a small strip A-A on the Jones lease beyond the area proven by Smith No. 1 but it is not a discovery. Jones No. 1 is drilled outside of either area and is claimed for discovery in the Gantz sand. Query whether the strip A-A may be revalued by the Jones lessee. It is understood that the Treasury Department has ruled in such a case that the strip A-A may not be revalued by the Jones lessee since the Smith No. 2 extended the proven acreage of the discovery.

Ruling. Where a partnership incorporated in 1917 and at the date of incorporation the property transferred was "proven terri-

tory," depletion was allowed the corporation on the basis of the cost to the corporation, i.e., the appreciated "discovery" value at which taken over, even though under Section 331[49] the corporation, for invested capital, could not include any such appreciation. (I-1-10; A. R. R. 712.)

Comment on the regulations.—The expressed purpose of the law is to permit annual allowances for depletion, based on output, up to the cost of the wells, and the intention of the numerous rulings and regulations has been to carry out the provisions of the law. The most that any owner can desire to charge off against income is the fair value of the property March 1, 1913, or the entire cost of property acquired or the fair value of discoveries since that date. He recognizes that any net income realized in excess of such amount is profit and should be taxable.

In some cases owners desire to charge off too much annually and in other cases they do not charge off enough. Those who charged off too much prior to January 1, 1917, regret their action because there is now so much less left to claim as allowable deductions under laws levying higher taxes. On the other hand, conservative financing and accounting require liberal reserves for depreciation and depletion, and the concern which has followed this policy should continue it and make such adjustments between the books and the tax returns as will reflect the true state of affairs. An oil company with a large cash investment cannot afford to ignore depletion or exhaustion. Aside from new purchases, it is obvious that at the end of any period the product remaining in the ground is less than at the beginning of the period by exactly the amount which has been extracted.

New wells brought in may increase flow and there may be an apparent appreciation in values rather than depreciation, but when such hazardous properties as oil wells are under consideration the tendency of good managers is to be pessimistic about the future and to be liberal in setting up depletion re-

[49] 1918 law.

serves. This policy prevents the overstatement of assets and the payment of excessive dividends. It may save a company from bankruptcy. The government will not lose anything in taxes in the long run by permitting liberal depletion deductions. It will probably gain, because the instant the entire investment is written off the books no further deductions for depletion can be claimed and under graduated income and excess profits tax laws the aggregate tax is increased. From the taxpayer's point of view, it is better to pay too much tax in the long run and have a conservative balance sheet, than to ignore depletion or provide insufficient reserves and publish misleading balance sheets.

Determination of the Depletion Allowance

Having determined the value of the property as at the date of valuation (the "basic date"), the next step is to determine the depletion unit, which is ascertained by dividing the value of the property by the number of units of mineral estimated to be in the property. The unit value multiplied by the numbers of units sold during the year gives the depletion allowance.

Regulation. (a) Depletion attaches to the annual production "according to the peculiar conditions of each case" and when the depletion actually sustained, whether legally allowable or not, from the basic date, equals the cost or value on the basic date plus subsequent allowable capital additions, no further deduction for depletion will be allowed except in consequence of added value arising through discovery or purchase. . . . .

(*b*) When the value of the property at the basic date has been determined, depletion sustained for the taxable year shall be computed by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold or produced within the taxable year. The depletion deduction for the taxable year is subject, however, to the limitation contained in article 201 (h).[50] In the selection of a unit for depletion preference shall be given to the principal or customary unit or units paid for in the product sold.[51] (Art. 210.)

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[50] See page 1211.

[51] [Former Procedure] Before the revision of December 29, 1920,

In (a) "production" is mentioned, but in (b) reference is made to the "units sold or produced." It is obvious that the quantity extracted represents actual depletion, because coal and other natural resources are frequently consumed by the taxpayer and not sold.

Depletion of mines.—In copper mines the practice is to multiply the depletion factor by the number of net tons of ore smelted or by the number of pounds of metal recovered or produced from ore smelted.[52]

In establishing the depletion rate care must be taken to use a rate that will provide for the proper deduction based on the grade extracted. If high grade ore is extracted during the early years, and low grade in the latter years, an average rate might fail to recover the full capital because in the later years the income might be insufficient. The effect of improperly using an average rate may be seen from the following:

Assume that the copper in this mine is 1,000,000,000 lb. of which the high-grade ore averages two-thirds, or 666,000,000 lb., and the low-grade ore amounts to, approximately, 333,000,000 lb. The profit on the high-grade ore is 10 cents, or $66,000,000 in round figures, and the profit on the low-grade is 5 cents, or $16,000,000. Adding these figures together gives a total value of $82,000,000. Assume a life of 10 years; this gives an expected annual income of $8,200,000. The present value of that income would be in round figures $66,500,000. Applying the Treasury rule to those figures for depletion, you must divide the $66,500,000 by the total number of pounds of copper, or 1,000,000,000, and be allowed a depletion of 6.65 cents per pound. In the first years when we get a 10 cent profit, all is well, we readily obtain the depletion of 6.65 cents, but in the latter years of that mine's life, when we only have a 5 cent profit on that ore, how can we take 7 cents out?[53]

The point is that the extraction of 100 pounds of copper

Art. 210 provided for computing the depletion allowance based on the number of units *extracted* during the year. See *Income Tax Procedure*, 1920, page 770.

Reg. 45 (1920 edition), Art. 210, based the allowance on number of units *sold*. See *Income Tax Procedure*, 1921, pages 936-937.

[52] T. O. McGrath, *Mine Accounting*, page 72.

[53] L. C. Graton, *Federal Taxation of Mines*, page 57.

contained in rich ore results in a greater impairment of the mine, because of the greater profit in the high grade ore than does 100 pounds of copper in low grade ore in which there was little profit. The problem may be solved in some cases by separate valuations of the various blocks of ore, where it is feasible to do so, as provided in article 206,[54] and the establishment of separate depletion rates applicable to each.[55]

In the case of a silver mine, this situation was recognized by basing the depletion, not on the tons of ore contained in the mine, but on the metal content of the ore. The unit of depletion was, therefore, the ounce of silver instead of the ton of ore containing silver. Each year's depletion allowance is based on the silver recovered (allowance having been made in the basic valuation for expected loss in extraction), which naturally varies as between different grades of ore. Note particularly the last sentence of article 210. The unit paid for in the product sold by a silver mine is not ore but silver, by a copper mine, copper not ore, etc.

Depletion of gas wells.—When gas wells have been valued on the basis of production, it is more practicable to use the production for calculating depletion for any given year than the pressure units suggested by the Treasury Department.[56] Depletion on the basis of production is the depletable capital sum divided by the estimated recoverable reserves (which equals the unit cost), times the number of cubic feet of gas produced during the year.

Depletion of oil wells.—

> Each barrel of oil or unit extracted and marketed must, before a profit can be realized, pay not only its proportionate share of the operating expense and deductions for depreciation and obsolescence of physical property, but also must pay its proportionate share of capital sum returnable through depletion allowances.

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[54] See page 1176.

[55] Recovery of the cost or March 1, 1913, value of the physical property may also be obtained through a depreciation deduction, based on the rate of current exhaustion of the mineral. See page 1105.

[56] *Manual for the Oil and Gas Industry* (1921), page 32.

> This proportionate share of capital sum returnable through depletion allowances, which each unit of oil must pay, is unit cost.
>
> Unit cost is obtained by dividing the capital sum returnable through depletion by the "estimated recoverable reserves" at the beginning of the taxable year. * * * *
>
> The depletion deduction is computed by multiplying the unit cost by the number of units produced during the taxable year.[57]

While the Treasury refers to units produced, as above, it also provides, in article 210, that depletion shall be computed on the number of units *sold* or *produced* during the year. In a year like 1921 when, with falling prices, producers were obliged to accumulate storage oil instead of selling all of their production to the pipe line companies, a considerable reduction in the total depletion would result if the basis of sales were adopted.

Limitation on depletion deduction based on discovery value.—The 1921 law[58] does not permit any part of the depletion deduction based on discovery value to be used in the computation of a net loss. This prevents the loss from being deducted from the income of a succeeding year, due probably to the "discovery" provision (which is first found in the 1918 law) being considered to be in the nature of a gift; and if the net income in any one year is not sufficient to take care of the full depletion charge based on discovery, there is no good reason for extending the terms of the gift to another period.

> Regulation. . . . . (*h*) Depletion allowance in case of discovery: The deduction for depletion in case of a discovery can not exceed the net income computed without allowance for depletion, from the property upon which the discovery is made, except where and to the extent that such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913. Net income is the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less operating expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion. If the mineral products are not sold as raw material

[57] *Ibid.*, page 30.

[58] Section 204; see page 1023.

but are manufactured or converted into a refined product, then the gross income shall be assumed to be equivalent to the market or field price of the raw material before conversion. Operating expenses, depreciation, and taxes on the property upon which the discovery is made, should be applied against the gross income from the same property on the basis of actual expenditures, but if the records for the year 1921 are in any case inadequate, allocation of such expenditures for that year may be made on the basis of the ratio of (1) the number of wells operated on the property on which the discovery is made to (2) the total number of wells operated in the operating division in which the discovery is included. (Art. 201.)

The following illustrations show how the limitation operates:

I

Net income from investments		$10,000
Net income from mineral property before depletion		50,000
Total		$60,000
Depletion charge based on cost or March 1, 1913, value	$40,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (amount of depletion charge based on discovery value, but not to exceed the net income from the property)		50,000
Taxable income		$10,000

II

Net income from investments		$10,000
Net income from mineral property before depletion		50,000
Total		$60,000
Depletion charge based on cost or March 1, 1913, value	$60,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (amount of depletion charge based on discovery value, which, if it exceeds net income from the property, is allowed up to the amount of depletion based on cost or March 1, 1913, value)		60,000
Taxable income		None

III

Net income from mineral property before depletion (no income from other sources)		$50,000
Depletion charge based on cost or March 1, 1913, value	$60,000	
Depletion charge based on discovery value	$80,000	

Depletion allowable (as above)		60,000
Net loss (which may be applied against net income of succeeding year—section 204)		$10,000

IV

Net income from investments		$ 5,000
Net income from mineral property before depletion		50,000
Total		$55,000
Depletion charge based on cost or March 1, 1913, value	$60,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (as above)		60,000
Net loss (which may be carried forward—section 204)		$ 5,000

The point is that the taxpayer may get depletion based on discovery value, if the net income is sufficient, but always gets depletion based on cost or March 1, 1913, value even if it results in a net loss, which net loss may be applied against the net income of a succeeding year under section 204.

Inventory to be market even though higher than cost.—If raw products are inventoried at the market price, as permitted by article 201, the latter may include a considerable element of profit. In so far as this may be a method recognized as representing the best accounting practice in the industry, it will be recognized by the Treasury. It is a good illustration of one of the five departures from the rule of cost or market, which ever is lower.[59]

Depletion accounts on books.—

Regulation. Every taxpayer claiming and making a deduction for depletion and depreciation[60] of mineral property shall keep accurate ledger accounts in which shall be charged the fair market value as of March 1, 1913, or within thirty days after the date of discovery, or the cost, as the case may be, (*a*) of the mineral deposit, and (*b*) of the plant and equipment, together with subsequent allowable capital additions to each account. These accounts shall thereafter be credited

[59] See *Auditing, Theory and Practice*, by R. H. Monegomery (1921 edition), page 122.

[60] See pages 1104-1108 for articles 222, 224 and 225 which refer to depreciation as well as depletion in connection with equipment.

annually with the amounts, whether legally allowable or not, of the depletion and depreciation sustained; or the amounts of the depletion and depreciation sustained shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus subsequent allowable capital additions, no further deduction for depletion and depreciation with respect to the property shall be allowed. (Art. 216.)[61]

Statement to be attached to returns.—

Regulation. (*a*) To the return of every taxpayer claiming a deduction for depletion or depreciation there shall be attached a statement setting forth with respect to each mineral property: (1) Whether taxpayer is a fee owner, lessor or lessee, (2) the date of acquisition and if under lease, its exact terms and date of expiration, (3) the cost of the property; stating the amount paid to each vendor, with his name and address, (4) the basic date at which the property is valued, (5) the value of the property on the basic date with a statement of the precise method by which it was determined, (6) the value of the surface of the land for purposes other than mineral production, (7) the estimated number of units of mineral at the basic date with an explanation of the method used in the estimation, and an average analysis which will indicate the quality of the mineral valued, (8) the number of units sold during the year for which the return is made, (9) the gross and net income derived from the sale of mineral, and in case of discovery the net income from the property upon which the discovery was made; (10) the amounts deducted for depletion, (11) the amounts sustained on account of depletion or on account of depreciation stated separately from the basic date to the taxable year, and (12) any other data which will be helpful in determining the reasonableness of the deductions claimed in the return.

Additional information in cases of fractional interests and leaseholds.—

(*b*) To the return of every taxpayer claiming a deduction for depletion in respect of (1) property in which he owns a fractional interest only, or (2) a leasehold, or (3) property subject to lease, there shall also be attached a statement setting forth the name and address and the precise nature of the holding of each person interested in the property, and every lessor shall attach to his return an affidavit stating, as of the date of filing the return, whether the lease involved is still in effect during the year covered by the return, and, if not still in effect, when it was terminated and for what reason and whether the lessor has repossessed the property.

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[61] See A. R. M. 124, page 1195.

(*c*) All statements required to be furnished in connection with the returns of taxpayers claiming depletion or depreciation must be under oath and may be included in a single affidavit. (Art. 217.)

Depletion may be deductible even if not on books.—As with depreciation, depletion charges should appear on the books and the book figures should conform exactly with those given in the returns. If it has not been the practice to record depletion, no time should be lost in making the proper book entries. However, the courts thus far have taken the position that the taxpayer cannot be deprived of the right to deduct depletion because of a failure properly to record the charges.

DECISION. The United States District Court has held that a coal company was entitled to a deduction of 15 cents for each ton mined as an allowance for depletion. The fact that this amount was incorrectly carried on the books of the company in surplus account instead of as depletion reserve did not justify the Government in disallowing the deduction.[62]

Under the 1921 law the Commissioner is authorized to require taxpayers to adhere to good accounting practice.[63] The courts may and should interpret this to mean that if depletion is not set up on the books the claim will not be allowed for income tax purposes. Moreover, the deduction claimed in the return should agree exactly with the books.

Depletion allowance to operating owner.—

REGULATION. In the case of an operating owner in fee, the amount remaining in any year returnable through depletion and depreciation deductions is (*a*) the cost or value of the property at the basic date plus (*b*) subsequent allowable capital additions and minus (*c*) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, and minus (*d*) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount returnable through depletion is the total

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[62] *Forty Fort Coal Co. v. Kirkendall, Collector,* 233 Fed. 704.

[63] [Former Procedure] The 1918 law had a similar provision [section 212 (b)].

capital remaining less the sum recoverable through depreciation. (Art. 202.)

Stockholder may not claim depletion.—It will be noted that a stockholder in a mining or oil or gas corporation is not entitled to any allowance for depletion, because the depletion claimed by and allowed to the corporation exhausts the allowable deduction.

REGULATION. . . . . Operating owners, lessors and lessees, whether corporations or individuals are entitled to deduct an allowance for depletion and depreciation, but a stockholder in a mining or oil or gas corporation is not allowed such deductions. . . . . (Art. 201.)

Depletion allowance to lessor.—The 1921 law[64] provides that "in the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee." The depletion allowance to lessors is fully discussed in the text following.

If the lessor is entitled to a sliding scale of royalties or if, as in the case of oil wells, he receives in addition to a bonus a specific part of the whole product (one-eighth of the product being a widely used figure), he will follow the same procedure as an owner who is also an operator. Revaluations as of March 1, 1913, may be placed on the books.

When leases are for a fixed royalty per unit, appreciation in value between the making of the lease and March 1, 1913, usually accrues solely to the lessee. Appreciation which accrued prior to the making of the lease which was in effect at March 1, 1913, inures to the benefit of the lessor in apportioning the depletion allowance between lessor and lessee.

The lessor having divested himself of any return beyond the royalties, cannot participate in appreciation as such. If interest rates were lower at March 1, 1913, than when the leases were made, the lessor might claim an increased value for the property, *subject to the lease*.

[64] Sections 214 (a-10) and 234 (a-9). The 1918 law included the same provision.

In all cases the lessor merely gets back through depletion his capital investment or value at March 1, 1913, and the lessee through depletion charges gets back his investment or value at March 1, 1913; and in no case must the aggregate depletion charges allowed to lessor and lessee exceed the aggregate capital investment.

Regulation. (*a*) In the case of a lessor, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

(*b*) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(*c*) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is the en bloc value of the mineral in the ground on March 1, 1913, and will, in the absence of satisfactory evidence to the contrary, be presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

(*d*) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

(*e*) The value of a lessor's equity in a mineral property under lease for a portion of its operating life is the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated en bloc value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.

(*f*) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is its cost.

(*g*) The value of a lessor's equity in a discovery on or after March 1, 1913, is the fair market value at the date of discovery, or

within thirty days thereafter, of his equity in the mineral discovered.[65] (Art. 204.)

The application of the principle laid down in paragraph (e) in the foregoing regulation, as affected by the 1916 law, is stated in the following:

RULING. The question is raised as to the proper construction to be placed upon Solicitor's Memorandum 1365 in so far as it relates to the computation of deductions for depletion of a mine allowed to a lessor.

The inquiry is made in connection with the following statement of facts: A leases a property to B in 1910 at 20 cents a ton for the period of 10 years. In 1913 it is determined that the property is very valuable, and has a large tonnage of ore which will extend its life, at the probable rate of extraction, until 1940. In 1920 A renews the lease to B for the life of the mine at a royalty of $1.00 per ton.

In Solicitor's Memorandum 1365 it is held that the allowable deduction for depletion *in that case* under the Act of September 8, 1916, i.e., the maximum amount that could be deducted, was to be determined by dividing the fair market value of the entire body of coal in place on March 1, 1913, by the estimated content of the mine in tons and multiplying the result so obtained by the number of tons of coal taken out each year, in accordance with article 172, Regulation 33 (revised). The lease there considered was entered into June 12, 1914. There was no evidence in the case that the value of the coal in place had increased between March 1, 1913, and the date of the making of the lease, and it was stated that the lease, which was for the term of 10 years, was coterminous with the life of the mine. The decision was based upon these facts and was clearly correct.

Section 12(a) Second (b) of the Revenue Act of 1916 provides

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[65] **[Former Procedure]** Article 202 before amendment in 1920 erroneously provided that a lessor could not claim any part of discovery value. See *Income Tax Procedure,* 1920, pages 771-772.

In an opinion of the Attorney General, dated October 29, 1920, it was held:

RULING. (1) The deduction for depletion in the case of mines, oil and gas wells, as the result of discovery on or after March 1, 1913, is allowed only to the party or parties in possession at the time of the discovery, and not to subsequent purchasers.

(2) The value which may be set up in the case of the discovery of mines, oil and gas wells, pursuant to the second proviso of section 234 (a) (9), Revenue Act of 1918, to be depleted in accordance with such reasonable rules and regulations as the Commissioner of Internal Revenue and the Secretary of the Treasury may prescribe according to the peculiar conditions in each case, is, in the case of a lease, to be equitably apportioned between the lessor and the lessee. (C. B. 3, page 175; T. D. 3089.)

for a deduction in the case of mines of a "*reasonable allowance* for depletion . . . . *not to exceed* the market value in the mine." It is clear from this language that it was not the intent of Congress that an owner of a mine who had leased it for a fixed royalty, thus putting a limit upon the amount which he could receive in any event, should recover all the value of the ore in place as of the basic date, but only that he should be allowed a deduction for depletion to the amount of his interest in the ore extracted, *not in excess* of the cost of the mine or its fair market value as of March 1, 1913.

In the case now presented the value of A's interest as of March 1, 1913, in the ore in the mine was the present worth as of that date of his royalties of 20 cents per ton, obtained by multiplying the royalty per ton by the number of tons probable extraction by the lessee and discounting the product for the remaining life of the lease, plus the value of the ore which would be left in the mine at the termination of the lease. The fair market value of the ore in the mine as of March 1, 1913, having been determined, "a reasonable allowance" to the lessor for depletion under such lease was the then present worth of his royalties, provided this did not exceed such fair market value. Upon the renewal of the lease in 1920 for the remaining life of the mine the lessor's interest in the capital sum will again be represented by the royalties stipulated to be paid, capitalized and discounted as above, and this present worth divided by the estimated mineral content of the mine at the date of the lease will equal the unit of depletion which, multiplied by the number of tons extracted in any year, will give the allowable deduction for depletion for such year, provided always that such deduction does not exceed the value as of March 1, 1913, of the ore extracted during such year.

The above ruling is not understood to modify the conclusion reached in Solicitor's Memorandum 1365, but only to apply the principle therein laid down to the different facts here presented. (C. B. 4, page 195; Sol. Op. 80.)

Assume that the mine leased in 1910 contained at March 1, 1913, 2,700,000 tons, annual production 100,000 tons, so that when the lease terminated in 1920, at the end of seven years, 2,000,000 tons would be left. The lessor then renews the lease at $1 royalty per ton. The Treasury says, in effect, that, since under the 1916 law the depletion deduction in any one year is limited to the "market value in the mine" of the ore removed, such market value was the present worth in 1913 of the 20-cent royalty fixed in 1910. Permission to recover any additional part of the value of the mine at March 1, 1913,

(under the 1916 law) would not be granted until the termination of the lease in 1920, under which stipulated royalties of 20 cents were paid. The following illustration will help to make this clear.[66]

Number of tons in mine at March 1, 1913		2,700,000
Number of tons lessee would extract between March 1, 1913, and termination of lease in 1920 (say 7 years)		700,000
Number of tons remaining in mine at 1920 (which would be extracted by 1940)		2,000,000
Production per annum, estimated at	100,000 tons	
Value of A's interest at 1913:		
Present worth of royalties to be received from 1913 to 1920: 100,000 tons × 20 cents = an annuity of $20,000, discounted at 6% for 7 years		$ 111,647.62
Add: Value of ore remaining at end of lease in 1920:		
Estimated profit per ton of ore remaining at 1920	$ .25	
Operating profit from 1920 on, of ore then remaining, 2,000,000 tons at 25 cents	$ 500,000.00	
$500,000 ÷ 20 = $25,000, or annual profits 1920 to 1940.		
Present worth of an annuity of $25,000 for 20 years at 6%	$ 286,748.03	
Since the realization of the value of the ore in 1920 ($286,748.03) is deferred for another 7 years (1913-1920), such value must be further discounted. Therefore, present worth of the entire $286,748.03 at 6% is		190,703.78
Total value of A's interest at March 1, 1913		$ 302,351.40
Depletion allowed A from March 1, 1913, to end of lease in 1920 is the present value of his royalties under the lease, or, as stated above,	$ 111,647.62	

[66] In a case with which the author is familiar, the problem was to determine the value as at March 1, 1913, of the royalties to be received by the lessor. At that date it was estimated that the mine would be worked out in nineteen years. The lessor sold its interest in 1917, taking in payment non-interest bearing notes maturing semi-annually, running to 1951, and through the acceptance of those notes the life of the mine, so far as the lessor was concerned, was in effect extended to 1951. The Treasury related this after discovered factor of longer life back to 1913, when as a matter of fact it had no bearing on the estimate of nineteen years' life made in 1913, which was based on the rate at which the mine was being exhausted.

Upon removal of the lease in 1920 the capital value at that date[67] would be 2,000,000 tons × $1 (the new royalty rate)	$2,000,000.00	
Present worth of an annuity of $100,000 ($2,000,000 ÷ 20) for 20 years at 6% = value of A's interest in 1920, or		$1,146,992.10
But, for purposes of depletion deductions allowable to A in the years 1920-1940 for the 2,000,000 tons, the value would be restricted to the March 1, 1913, value thereof, determined as above to be......	$ 190,703.78	

In valuing his equity at March 1, 1913, the lessor is justified in assuming that at the end of the lease not then terminated new rates will be effective and that the new rates will be as much higher relatively as the March 1, 1913, rates exceed the rates in existing leases.

As stated by an authority:

In the case of term leases, ... the value of the property should be calculated, taking into consideration the probable going royalty of the region at the time of release or renewal, rather than calculating for the entire life of the property, at the royalty of the lease, which will probably be far lower than the new royalty obtainable.[68]

BONUS IN ADDITION TO ROYALTIES.—

REGULATION. (*a*) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition. . . . . (Art. 215.)

[67] Calculated solely for the purpose of corroborating the conservative estimate of 25 cents per ton as of March 1, 1913.

[68] R. V. Norris, discussion of L. C. Graton's paper, *Federal Taxation of Mines*, page 43.

In a recent case one of the questions as to bonuses was: Where annual payments of large amounts in addition to stipulated royalties were made, could the receipt of such payments be considered by the lessor as bonuses?

Ruling. . . . . Upon first reading, it would appear that the above-quoted article[69] is controlling of the questions presented by this case. A careful examination discloses, however, that the term "other sum" means a sum of money in the nature of a bonus which is paid for the delivery or assignment of a lease and does not relate to rental payments which are made for the purpose of continuing the occupation and use of property. The annual cash payments in this case are not bonuses, or in the nature of bonuses, and therefore not within the meaning and spirit of said article 215(a).

It is to be observed that throughout the lease instrument the annual cash payments are described and referred to as rentals and not as bonuses. It is to be further observed that the obligation on the part of the lessee to make these payments is independent of any mineral production. If no development work is done or operations performed, the obligation to pay these fixed amounts remains as long as the lease continues in force. Where no mineral is produced upon the premises it follows that the interest of the taxpayer in the mineral reserves is not affected and that no allowance can be made for depletion. Under such conditions to treat the annual payments of 50x dollars each as a return of capital would be the equivalent of making an allowance for depletion when no depletion has been sustained.

In the same ruling the other question involved was whether the property leased, and for which bonus was received by the lessor, had value at March 1, 1913, against which to apply the bonus payment.

The payments under the aforesaid leases are unquestionably in the nature of bonuses, but before they can be treated as returns of capital under article 215 it must be shown that the leased lands had a value for mineral purposes on March 1, 1913. If the lands had no value for such purposes on that date, then there would be no capital remaining to be recovered through allowances for depletion. There would be nothing against which a depletion deduction could be taken. The ascertainment of values is a function of the Natural Resources subdivision of the Income Tax Unit and it has already determined that this property had no value for mineral purposes on that date and as far as it appears it has no such value today. The land lies

[69] Art. 215 (a).

outside of the producing area and no evidence has been submitted which indicates any mineral value. It is, therefore, the opinion of this office that the 18 1 5*x* dollars paid by the aforesaid lessees upon the execution and delivery of the leases should be treated as income . . . . (I-5-56; A. R. M. 148.)

The ruling states that the property "has no value today." The lessees paid a considerable sum, apparently for the opportunity to explore the property, which must have seemed valuable to them. Similarly, at March 1, 1913, other persons may have considered the property to have prospective value. One of the tests is what a prospective lessee would pay.

Restoration of bonus written off.—

Regulation. . . . . (*d*) Upon the expiration, termination or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from the amount returnable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned. (Art. 215.)

Apportionment of depletion between lessor and lessee.—The following comment on the allocation of depletion between lessor and lessee is of interest.[70]

The clause requiring the lessor and lessee "to equitably apportion the allowances on the basis of their respective interests," is perfectly just, but quite impracticable in application. From long experience in the relations of lessor and lessee it seems most improbable that such apportionment could be made except through the action of the courts, or of some commission having the necessary authority.

It seems wise not to attempt the apportionment required but to value the interests of lessor and lessee separately, using recognized methods of valuation.

The two estates of lessor and lessee in the case of royalty "leases" of natural resources are essentially separate. That such a "lease" is a sale of mineral in place has been repeatedly decided by the Supreme Court of Pennsylvania (31 Pa. 475; 105 Pa. 466-472; 94 Pa. 15; 109 Pa. 583; 123 Pa. 240; 144 Pa. 613; 143 Pa. 293; 240 Pa. 234; etc.

[70] R. V. Norris, *The Taxation of Income from Mining*

Depletion allowance to lessee.—The 1921 and 1918 laws fully recognize that leases are property and may be revalued as of March 1, 1913, such value to be returned to the lessee through depletion charges without any tax being levied. This point is settled by the specific provision that "the taxpayer's interest" in "the fair market value of the property" acquired prior to March 1, 1913, is the basis of the deductions permitted. In the opinion of the author lessees have always had the same rights and privileges, in regard to depletion, as were accorded to owners under the 1913 and 1916 laws.[71]

REGULATION. (*a*) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

(*b*) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(*c*) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

(*d*) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

(*e*) The value of a lessee's equity in a discovery on or after

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[71] For former procedure and criticism of regulations and rulings, see *Income Tax Procedure*, 1918, pages 409-410, and *Income Tax Procedure*, 1919, pages 611-613.

The following ruling in 1920 is based upon Regulations 33, many articles of which have been overruled:

RULING. . . . . Article 171 of Regulations 33, revised, provides that: "The deduction in the case of a lessee [of a mine] will be limited to an amount equal to the *capital actually invested in the lease*, without regard to value as of March 1, 1913, or any other date."

. . . . It is therefore held that where a corporation, organized for the purpose, takes over a mining lease, issuing its entire capital stock to the individual owners of the lease in the proportion of their respective interests therein the "capital actually invested in the lease," for the purpose of the deductions allowed by section 12 (a) of the Act of September 8, 1916, is the fair market value of the stock so issued. (C. B. 2, page 145; O. 1033.)

March 1, 1913, is the fair market value at date of discovery or within thirty days thereafter, of his equity in the mineral discovered. (Art. 203.)

In a recent decision[72] the court held:

Decision. The question of law presented for decision is whether or not the plaintiff is entitled to deduct a reasonable allowance for depletion of iron ore from the gross amount of its receipts from all sources in order to determine the net income subject to tax. The answer to this question turns on the true meaning of section 12 of the Revenue Act of September 18, 1916. The government's contention is that the deduction authorized by the second subdivision of this section is allowable only to an operating owner of an ore mine and not to an operating lessee under a lease of the character stated. . . . .

I have carefully examined all of the cases decided under the corporation tax act of 1909 and under the several income tax acts and have also carefully studied the several provisions of these several acts so far as they relate to this question. My conclusion is that the operating lessee is entitled to the deduction as claimed.

Upon appeal to the Circuit Court of Appeals, Sixth Circuit, the district court was reversed. A careful reading of the opinions of the two courts indicates that the district court decided the case on its merits, while the circuit court depended almost entirely on the decision in the Biwabik case.[73] Not only did that case arise under the 1909 law (which did not provide specifically for depletion) but in referring to it the court said:

Decision. . . . . the nature of the interest held by the lessee was not such as to permit it to claim the allowance, but . . . . the contingencies which attended the character of the lessee's interest barred it from claiming that its capital assets had been diminished.

The circuit court also said:

Decision. . . . . In the Biwabik case, the lessee was not heard to say that his capital assets had been consumed by his mining operations, and we interpret that decision as resting in an essential degree on the idea that the nature of the lessee's title forbade him to make this claim. We cannot read the decisions of the Supreme Court as

[72] *Mohawk Mining Co. v. Weiss, Collector*, U. S. Dist. Court, Northern District of Ohio, Eastern Division (November 3, 1919); reversed June 15, 1920 (264 Fed. 502). Writ of *certiorari* denied by Supreme Court, October 18, 1920 (254 U. S. 637).

[73] *United States v. Biwabik Mining Co.*, 247 U. S. 116.

having determined that the exhaustion of ore reserves is so inherently a business loss, rather than an impairment of capital, that a statutory grant of the right to deduct for depletion on that account will reach a case which has been adjudged not to involve the diminution of capital assets. We think the substantial principles established by the decisions are that both the royalty received by the fee owner and the sums received by the operating lessee above the cost of operation are income; that the statutory reduction for "depletion" cannot be twice credited, once to the fee owner, and once to the lessee; and that the exemption belongs of right to the fee owner.

It is difficult to infer from the foregoing that a lessee is not entitled under the 1916 law to depletion of the March 1, 1913, value. The special circumstances of the case seem to have been a factor in the decision. The conclusion that an allowance for diminution of capital value after March 1, 1913, accrues solely to the owner or lessor, even though the royalties or rentals thereafter are fixed, is not logical. It would mean in many cases that the lessor could claim depletion equal to the gross royalties or rent collected.

The synopsis of the decision appearing on page 208 of the report of the Commissioner of Internal Revenue for 1920 is not as complete as it should be.

Bonus deductible by lessee through depletion.—

Ruling. Under an option to purchase or so-called "bond and lease" agreement, providing for the payment of royalties on ore mined and for the payment at stated times of the amounts necessary to bring the total amounts paid to certain specified sums, and giving an option to the purchaser to take title to the property upon the payment of a specified amount upon which the royalties and deficiency payments are credited as part of the purchase price, the amounts paid as royalties constitute operating expenses and are deductible as such in determining net income.

The additional sums paid to make up the amounts of the several installments when due are capital investments in the nature of bonuses recoverable through deduction for depletion, computed upon the total sum of such additional payments to the end of the tax year.

Where, as in this case, the option is forfeited, the capital sum remaining to be recovered is deductible as depletion in the return for the year in which the forfeiture occurs. . . . . (C. B. 4, page 138; Sol. Op. 86.)

Lease as distinguished from sale.—Mining "leases" sometimes partake of the nature of a sale of the ore in place, and before a determination of the depletion deduction it may be necessary to ascertain whether or not the contract constitutes one a lessee. In the foregoing ruling (Solicitor's Opinion 86) the Solicitor, referring to the option to purchase or so-called "bond and lease," quotes:[74]

> It is often difficult in a given instance to find a technically correct legal name for the contract employed for it may possess some of the characteristics of two or more well-defined classes. What is more important, however, from a practical standpoint is to ascertain from the contract what are the respective rights of the contracting parties.

In another case involving the construction of timber contracts, the Treasury ruled that the contracts conveying title to timber cut and removed from the property constituted leases and not sales of the standing timber.[75]

Depletion sustained but not allowed under previous laws.—As heretofore stated,[76] the income tax laws of 1913 and 1916 imposed limitations upon the deduction for depletion.

Ruling. The amount recoverable by a taxpayer without liability to tax under the War Revenue Act of 1918, either by way of deduction for depletion or of the return of capital upon the sale of the property, is the cost of the property, its fair market value at March 1, 1913, or within 30 days after discovery, as the case may be, minus the amount of depletion (based upon the same cost or value) actually sustained prior to January 1, 1918, whether or not all of such amount has been allowed for the purpose of computing net income under earlier income tax laws. (C. B. 1, page 141; T. B. R. 4.)

The foregoing ruling has not been sustained by the courts and good authorities doubt if it will be sustained. It is argued that the 1918 law requires that the capital to be returned free of tax is cost or value March 1, 1913, and that the depletion which was not deductible cannot be considered, otherwise part

[74] *Lindley on Mines*, sections [illegible].
[75] C. B. 4, page 201; A. R. M. 111.
[76] See page [illegible].

of the cost or value March 1, 1913, will be taxed. The following ruling is cited as a precedent:

RULING. Inasmuch as no deduction for depreciation of the personal residence of a taxpayer is allowable in his income tax returns, a taxpayer in determining the gain or loss arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its fair market value as at March 1, 1913, by the depreciation sustained. (C. B. 3, page 46; O. D. 600.)

Development costs.—Development costs, as heretofore, may be added to capital investment and charged off thereafter as a part of depreciation or depletion, or if the items can be held to be proper operating costs they may be omitted from the annual deduction and charged direct to maintenance.

To the cost of the fee or the lease for the purposes of depletion there may be added in the case of both owner and lessee, "the cost of subsequent improvements and development not charged to current operating expenses."

Oil and gas operators (as distinguished from mines) have the option of charging as expense or of capitalizing major items, such as cost of drilling wells.[77]

Depletion basis for discoverers.—The 1921 law continues the provision first found in the 1918 law which, in effect, permits the original discoverer of a mine or an oil well to set up the market value of a new discovery as a basis for depletion charges, when the discovery is after March 1, 1913, and irrespective of cost, provided the cost is materially disproportionate to the value.[78]

It has been assumed by some that the statement in the law, to the effect that as to all discoveries on and after March 1, 1913, the discoverer shall get back the market value through depletion, justifies amended returns for prior years so that the depletion charge shall commence in the year of discovery.

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[77] See page 1107.

[78] Sections 214 (a-10) and 234 (a-9). For mines, see page 1194. For oil and gas wells, see page 1205.

The author does not so interpret the law. There is no doubt about the right of a discoverer to charge depletion on the basis of value instead of on cost, but it was hardly the intention of Congress to permit the increased depletion charge before January 1, 1918.

There is no doubt, however, of the right to revalue at any time after March 1, 1913. If a discoverer paid $1,000 for unproven acreage in 1915, and discovered oil thereon worth $1,000,000, he would be entitled to charge depletion up to January 1, 1918, on only the $1,000. Commencing January 1, 1918, he may charge depletion on the $1,000,000 revaluation.

While depletion *deductions* from income for the years prior to 1918 would be based on cost ($1,000), the depletion *sustained* from date of discovery (1915) would be computed on the basis of the discovery value ($1,000,000). The depletion not allowed as a deduction prior to 1918 would represent realized appreciation. Not having been charged against income, it would be reflected in surplus. After January 1, 1918, the depletion based on the excess of discovery value over cost, representing appreciation realized, would be included in invested capital.[79]

Discovery value under lease from government.—

Ruling. Where a taxpayer made claim under the placer mining laws to public land, which was withdrawn by Executive order prior to completion of valid location (and prior to Mar. 1, 1913), and later (subsequent to Mar. 1, 1913) operated the land under agreement with the Secretary of the Interior, or lease from the Government, he is not entitled to a depletion deduction based upon the value of his claim as of March 1, 1913, but, under the provisions of the Revenue Act of 1918, he is entitled to a depletion deduction based upon the discovery value as to discoveries made subsequent to the acquisition of the lease or leases from the Government. (B. 36-21-1801; Sol. Op. 118.)

Advance royalties—depletion basis.—Leases of mineral lands frequently provide that minimum royalties must be paid

[79] See Appendix A, Chapter X.

in advance, irrespective of mining operations. The question arises as to whether a lessor should be entitled to claim an allowance for depletion as directly chargeable against the royalty receipts, or whether he should be entitled to the deduction only if and when it can be shown that the number of units for which a deduction is claimed have been removed from the ground. If the lessee fails to remove the stipulated quantity within the period mentioned in the lease or for other causes, the lessor may repossess the property. In such case he will find himself in the embarrassing position of having claimed a deduction covering the removal of a given number of units, whereas his property is intact or a less quantity has been extracted than has been claimed. So much for the government's side.

If the lessor receives advance royalty payments during one period, and cannot claim an allowance for depletion until some subsequent period when proof can be offered to support the claim, it may be that the tax on the royalties reported as gross income will be at a higher rate than when the deduction is permitted. Or it may be that in the subsequent period the receipts will be small and the allowable deductions larger than the gross receipts. The matter is important if graduated tax rates are involved. So much for the taxpayer's side.

In the regulations the Treasury takes a liberal attitude. Owners in receipt of royalties must report royalties as taxable income but are permitted to deduct depletion even though there has been no extraction during the taxable year. It is, however, provided that if the deductions are found to be unwarranted because the minerals were not really taken out, upon repossession the amount theretofore claimed for depletion must be returned as income for the year when the property is repossessed. The actual effect of this might be the imposition of an extremely large tax for one year. It would be more equitable if amended returns were permitted.

Dividends declared out of depletion reserves.—Certain mining companies have paid dividends which have been declared to be out of depletion reserves instead of earned surplus. For a discussion of this practice, see page 743.[80]

Depletion basis when resources are unworkable within reasonable period.—The usual rule is that depletion charges represent the book value of the quantity mined at the per unit value, established by dividing the cost or the March 1, 1913, value, by the entire estimated contents of the mine. This rule works well in all cases when the life of a mine is short. In practice it works well also when the life of a mine is not short because it is not customary to include in the aggregate contents of a mine the ore or coal which cannot be mined within a reasonable time. Otherwise the owner of a mine would receive credit for an insufficient depletion charge during the early years of operation.

The reason is that, in effect, nothing is paid for the ore or coal in the ground which cannot be reached by ordinary mining methods within a reasonable number of years. If the regulations were literally followed it would result inequitably and would not return the capital of the owner or lessor as the law provides.

A copper or anthracite mine might have an estimated life of 100 years, but no sane purchaser would tie up any of his capital for 100 years. The fair market value of mining property is based on the possible (or probable) extraction of the mineral content during, say, 20 or 30 years or more, depending on the circumstances of each case; and this aggregate quantity if determined by careful estimates is the proper amount by which the cost or value of the mine should be divided to ascertain the per unit cost for depletion purposes.

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[80] **[Former Procedure]**

REGULATION. . . . . If dividends are paid out of a depletion or depreciation reserve, the stockholders must be expressly notified that the dividend is a return of capital and not an ordinary dividend out of profits. . . . . (Art. 216, prior to amendment by T. D. 3107, dated December 29, 1920.)

Engineers who have given much thought to this subject suggest that the *maximum* be 45 years.

Appraisals of oil and gas wells in the United States at the present time rarely show a maximum life of more than twenty years.

If all future and prospective extraction were to be considered as an element of the calculation it would be necessary to include as a factor the question of interest on capital. In other words, if the entire possible contents of a mine were to be used as a divisor it would be necessary to compute the depletion charge on a sliding scale. It might be that the total contents of a mine would be estimated at 1,000,000 tons. If the cost or value at March 1, 1913, were $100,000, the theoretical depletion charge would be 10 cents a ton, but if part of the contents could not be extracted for 50 years it would be evident that the purchaser did not pay 10 cents a ton for that part of the contents which would not be mined for 40 or 50 years. The capital invested was intended to cover only the extraction during a period which warranted an investment.

If the capital were spread over a period longer than twenty or thirty years, the owner would expect in some way to be recompensed for the use of long time capital investment through the equivalent of an interest return.

The simplest method of handling a case of this sort would be to segregate any part of the estimated contents not removable within a profitable period, and, if it represented any capital investment, such part of the asset should be carried to a separate account designated as investment not subject to depletion. If that part of the property were opened subsequently, depletion charges would commence as if it were a new property. The investment in the mine which the owner knows will be operated and expects to have repaid through depletion charges would then appear at cost or March 1, 1913, value; and the resulting book value of the investment divided by the quantity removable within a reasonable time would give the unit value for depletion purposes.

It may be urged that at the end of each year a certain quantity of mineral has been extracted, but its place is taken, in effect, by an equal quantity which at the end of the year has in point of time been moved forward from just outside the period to just inside the period. So year by year the depletion is made good by other mineral covered by the original purchase. If this line of reasoning were sound no depletion should be allowed. But the reasoning is not sound.

In most cases in which the extent of the deposits is known at the time of purchase there is a definite distinction drawn as to the value after a certain number of years, and there is the expectation that the cost of mining after a certain period will be too great to meet the competition of more favorably situated deposits. In such cases the postponement of the depletion charge would be unfair. If the later costs of mining, due to the depth of the deposit, for instance, were far greater than the earlier costs, it is conceivable that there would be no margin to cover high enough depletion in the aggregate to return the entire capital invested.

The court decisions establish the principle that the capital invested in specific property represents the amount which must be returned to the taxpayer free from the tax. Therefore, if it were shown that at the time of purchase there was a specific amount of capital invested in a specific tonnage, the purchaser would be entitled to a return of such investment in the way of depletion charges, irrespective of additional tonnage which at the beginning may have been undeveloped and in effect is not reflected in any capital investment whatever.

Furthermore the quantity of mineral to be extracted after, say, thirty to forty years is always uncertain. If additional quantity becomes valuable or realizable while the quantity workable within a reasonable period is being extracted it is in effect appreciation and is not taxable until actually realized. Then, too, when it is realized the entire net recovery will be taxable as the book investment will have been written off.

Appreciation in land values is not allowed to offset depreciation in the value of buildings. (See page 1050.)

Timber-Forest Industries

While the principles underlying the valuation of the natural resource and the computation of the depletion allowance are in general the same for timber as for mines and for oil and gas wells, there is a very important difference in that the "discovery value" provision[81] of sections 214 (a-10) and 234 (a-9) does not apply to timber. There are, of course, other differences in the details of the computations because of the different physical characteristics of timber as compared with minerals.

Regulations in regard to forest industries are comprehensive and are reproduced in full except when the provisions are the same as for mines, etc.

The Treasury has issued a questionnaire (form T) consisting of 36 pages which should be in the hands of all who are interested in the valuation or taxation of forest industries.[82]

Depletion of timber.—

Regulation. A reasonable deduction from gross income for the depletion of timber and for the depreciation of improvements is permitted, based (*a*) upon cost if acquired after February 28, 1913, or (*b*) upon the fair market value as of March 1, 1913, if acquired prior thereto. The essence of this provision is that the owner of timber property, whether it be a leasehold or a freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to its fair market value as of March 1, 1913, plus in any case the subsequent cost of plant, equipment, and development which is not chargeable to current operating expenses, but not including cut-over land values. (Art. 227.)

Computation of allowance for depletion of timber.—

Regulation. The allowance for depletion of timber in any taxable year shall be based upon the number of units of timber felled during the year and the unit value of the timber in the timber account or accounts, pertaining to the timber cut. The unit value of the

[81] See pages 1228-1229.

[82] Form T (Timber), 7 pages, is another schedule which must be filed with the return.

timber for a given timber account in a given year shall be the quotient obtained by dividing (a) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account into (b) the total fair market value as of March 1, 1913, and (or) cost of the timber on hand at the beginning of the year, plus the cost of the number of units acquired during the year, plus proper additions to capital. (See art. 231.) The amount of the deduction for depletion in any taxable year with respect to a given timber account shall be the product of (a) the number of units of timber cut from the given account during the year multiplied by (b) the unit value of the timber for the given account for the year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts see articles 235 and 236.

The depletion of timber takes place at the time the timber is felled.[83] Since, however, it is not ordinarily practicable to determine the quantity of timber immediately after felling, depletion for purposes of accounting will be treated as taking place at the time when, in the process of exploitation, the quantity of timber is first definitely determined. (Art. 229.)

Revaluation of stumpage, after March 1, 1913, not allowed.—

REGULATION. In the case of timber acquired prior to March 1, 1913, the fair market value as of that date shall, when determined and approved by the Commissioner, be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the timber was fixed, and during such ownership there shall be no redetermination of the fair market value of the timber for such purpose. However, the unit market (or cost) value of the timber will subsequently be changed if from any cause such unit market (or cost) value, if continued as a basis of depletion, shall upon evidence satisfactory to the Commissioner be found inadequate or excessive for the extinguishment of

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[83] Computing depletion on the basis of timber felled may be compared with the requirement of Art. 210, in the case of mines, that it be calculated on the number of units sold or produced.

the cost, or fair market value as of March 1, 1913, of the timber. (Art. 230.)

Revaluations based on discoveries after March 1, 1913, are not permitted as in the case of mines and oil wells.

Charges to capital and expense of timber properties.—The subject of the proper division of expenditures as between capital and expense items is treated in the chapter on Depreciation, pages 1119-1121.

Evidence required to support depletion charges.—

Regulation. To the income tax return of the taxpayer claiming a deduction for depletion or depreciation or both there shall be attached a map and statement (Form T-Timber) for the taxable year covered by the income tax return. Form T-Timber requires the following: (a) Map showing timber and land acquired, timber cut, and timber and land sold; (b) description of, cost of, and terms of purchase or lease of, timber and land acquired; (c) proof of profit or loss from sale of capital assets; (d) description of timber with respect to which claim for loss, if any, is made; (e) record of timber cut; (f) changes in each timber account as the result of purchase, sale, cutting, reestimate, or loss; (g) changes in physical property accounts as the result of additions to or deductions from capital and depreciation; (h) operation data with respect to raw and finished material handled and inventoried; (i) unit production costs, and (j) any other data which will be helpful in determining the reasonableness of the depletion and (or) depreciation deductions claimed in the return. Similar information is required for certain years prior to the 1919 taxable year from those taxpayers who have not already furnished it. The specific nature of the information required for the earlier years is given in detail in Form T—General forest industries questionnaire for the years prior to 1919. (Art. 233.)

Determination of interest of taxpayer.—The law[84] provides that the depletion is to be based on the taxpayer's interest in the property. Therefore, it is necessary to determine first what that interest is, as appears from the following:

Ruling. Where a lumber company in good faith purchased lands from a railroad company in violation of the grant of the lands to the railroad under an Act of Congress and subsequently, under a subse-

[84] Sections 214 (a-10) and 234 (a-9).

quent Act of Congress, compromised the litigation which had been instituted by the United States to declare a forfeiture of said lands by reason of the violation of the provisos of the grant, it did not thereby purchase complete title from the Government but only such title or interest as remained in the United States, nor did it relinquish whatever right, title, or interest it had acquired from the railroad company. By proceeding under the Act of Congress the parties compromised and adjusted their differences and the title of the lumber company to the lands was perfected and confirmed.

On March 1, 1913, after proceedings had been instituted under the Act of Congress to compromise the litigation between the United States and the so-called innocent purchasers, but prior to the issuance of patents for the land involved and the making of final payments therefor, the said purchasers had such an interest in the lands as would entitle them to an allowance for depletion. The value of that interest on the basic date was the value of the land less the amount paid to the United States as provided by the Act. (B. 46-21-1921; Sol. Op. 124.)

Determination of fair market value of timber.—

Regulation. Where the fair market value of the property at a specified date, in lieu of the cost thereof, is the basis for depletion and depreciation deductions, such value shall be determined, subject to approval or revision by the Commissioner upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of the particular date. Such factors as the following will be given due consideration: (a) Character and quality of the timber as determined by species, age, size, condition, etc.; (b) the quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber; (c) accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation, and the climate and the state of industrial development of the locality); and (d) the freight rates by common carrier to important markets. The timber in question will be valued on its own merits, and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned above, will be consistent with that of the other timber in the region. The Com-

missioner will give due weight and consideration to any and all facts and evidences, having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, value fixed by the owner for the purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried and (or) appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors. For depletion purposes the fair market value at a specified date shall not include any part of the value of the land. (Art. 234.)

The regulation states that the timber will be "valued on its own merits, and not on the basis of general averages for regions." In the case of some companies owning many tracts containing a variety of grades and species, and where it has been the well-settled practice for sales and purchases to be made on the basis of a general average for a particular section, the courts would probably sustain valuations made on such basis by those having experience enough to qualify as experts.

Revaluation affecting lessee.—

Ruling. A licensee of Crown Land Limits in the Province of Quebec, Canada, is to be regarded as a lessee for tax purposes and is not entitled to deduct depletion based upon the value of the timber as of March 1, 1913. . . . . (C. B. 3, page 178; L. O. 1055.)

The leases in question, however, were terminable in one year.

For the distinction between a lease and a sale of timber, see Chapter XV.

Determination of quantity of timber.—

Regulation. Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board-measure log scale, cords, or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate shall state as nearly as possible the number of units which would have been found present by a careful estimate made on the

specified date with the object of determining 100 per cent of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the net result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, and/or of errors in the original estimates, there are found to remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) shall be made, and, when made, shall thereafter constitute a basis for depletion. (Art. 235.)

Timber accounts.—

REGULATION. With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block," a block being an operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the Commissioner on audit, the taxpayer may divide the timber in a given block into two or more accounts, e. g., timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts, or individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts, or blocks may be divided into two or more accounts based on the character of the timber and (or) its accessibility, or scattered tracts may be included in separate accounts. When such a division is made, a proper portion of the total value, or cost, as the case may be, shall be allocated to each account.

The timber accounts mentioned in the preceding paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this article the land in a given "block" may be carried in a single land account or may be divided into two or more accounts

on the basis of its character and (or) accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, will be allocated to each account.

The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively.

Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

For good and substantial reasons to be approved by the Commissioner, or as required by the Commissioner, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts. (Art. 236.)

Depletion and depreciation accounts on books.—Since the requirements are practically the same as for mineral property,[85] the regulation for timber is omitted.[86]

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[85] Art. 216; see page 214.

[86] Art. 237.

CHAPTER XXXIV

DEDUCTIONS FOR CONTRIBUTIONS, DONATIONS, GIFTS AND SUBSCRIPTIONS

The 1921 law substantially re-enacts the provisions of the 1918 law regarding gifts and contributions.

Individuals are permitted to deduct contributions made to certain classes of organizations up to 15 per cent of their net income. The scope of the new law has been widened to include organizations not included in the 1918 law.

Partnerships may deduct from gross income such donations as are in the nature of business expenses, any others being prorated among the members and deducted in their individual returns.

Corporations have never been permitted to include gifts, as such, among their deductible expenses. There may be some merit in the argument which has been advanced that Congress did not give corporations the same status in respect to gifts which it has given to individuals because it felt it could not impliedly condone the wholesale giving away of stockholders' property by boards of directors; but the withholding from corporations of the privilege of deducting gifts does not prevent the making of so-called gifts which are deemed to be for the benefit of the business and which constitute ordinary and necessary expenses.

Gifts by individuals deductible within limitations.—

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(11) Contributions or gifts made within the taxable year to or for the use of: (A) The United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (B) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts

of the American Legion or the Women's Auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (C) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. In case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary;[1] . . . .

Gifts to United States, states, municipalities, etc., deductible.—The deduction of this type of gift is new. The provision of the law is restrictive in the sense that contributions of such nature must be for exclusively public purposes. A taxpayer who makes a donation to the United States or a political subdivision thereof, which meets the test of being for the general good of the public, may deduct in his tax return such expenditures up to the 15 per cent limit.

The policy of permitting deductions for gifts is sound and will be of benefit to the United States and political subdivisions thereof. Ordinarily when public improvements are made under the direction of public officials, the cost thereof is assessed to taxpayers in the form of municipal taxes. Such

[1] [Former Procedure]. The 1917 law included the words "associations" and "societies" as recipients. No mention of the rehabilitation act nor of non-resident aliens was made.

No deductions for gifts were permitted before the passage of the 1917 law.

Form 1040 (revised, 1918) erroneously limited the base upon which the allowance could be computed by eliminating the amount of dividends received in 1917, applicable to earnings of prior years. Subsequently the error was discovered and corrected. (Telegram to A. Iselin & Co., from Commissioner Roper, February 27, 1918.) The author's attention has been called to the fact that many taxpayers followed the original form and failed to obtain the credit to which they were entitled. If the correction of the error has not been called to the attention of taxpayers who erroneously failed to add to the total income shown on line M of the return the dividends applicable to prior years, claim can be made for the amount of tax overpaid and refund secured.

taxes are deductible in an individual's return. If public improvements are the gift of an individual citizen they are similar in some respects to taxes, in that the public receives benefit therefrom, and it is only reasonable that a limited deduction should be permitted, as is now provided in the present tax law.

The rules for valuing and reporting such gifts as prescribed by the Treasury must be adhered to.[2]

GIFT TO CITY FOR PARK PURPOSES.—

REGULATION. . . . . A gift of real estate to a city to be maintained perpetually as a public park is an allowable deduction under the present statute, but was not an allowable deduction under the Revenue Act of 1918. . . . . (Art. 251.)

Gifts to be deductible must be made to public association.—The law is not designed to cover private charity, such as assistance afforded to a needy relative or dependent; but the wording of the law is broad enough to include all contributions to churches and other recognized agencies, which in turn dispense aid to the needy.

RULING. Contributions which may be deducted in computing the net income of an individual taxpayer include not only donations to incorporated institutions, but those given to similar associations which are not incorporated. Contributions to war chest funds, war camp community funds, and similar funds which were raised solely for organizations supporting and furthering war relief, are likewise deductible items on personal returns, within the limit named in the law.

All gifts and donations to churches are deductible, it being held by the Bureau that every church constitutes a religious corporation or association for the purpose of this deduction. Donations to missionary funds, church building funds, or for church activities, which are intended for the furtherance of church work, constitute deductible items. . . . . (Statement by Bureau of Internal Revenue, February 28, 1919.)

The 1921 law specifically includes the terms "fund, or foundation," which broadens the class of organizations em-

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[2] See page 1247.

braced under this section of the law. Posts of the American Legion or Women's Auxiliary units thereof are now specifically included within this section.

The deductibility of such gifts will depend largely on the taxable status of the recipient organization. If no part of the contributed receipts inures to the benefit of any particular individual or individuals and it can be shown that the organization comes within the contemplation of the law, the amounts donated are deductible up to the limit specified.

Many such organizations have realized that the tax laws have operated in a peculiar manner to their benefit. They are in a position to receive relatively larger amounts as gifts than the expenditure represents to the donor, the difference being the amount "saved" under this section of the law. In other words, the organization receives the tax which the government would have received had the donation not been made. This condition will continue as long as the high surtax rates are in force.

Treasury's rulings holding gifts deductible.—The Treasury has passed upon a large number of cases involving gifts. Donations to the following organizations have been held to be gifts within the 15 per cent limitation provided by section 214 (a-11) : a memorial association which is organized for the purpose of erecting by public contributions a monument and building within which will be established and maintained a museum as a depository of the records, flags, literature and trophies of the late war, as well as a forum to be utilized for educational lectures and meetings, and educational in its nature and purpose;[3] an association incorporated under the laws of Porto Rico for the purpose of soliciting and obtaining donations to be used in reconstruction work and for charitable purposes in portions of Porto Rico devastated by

[3] C. B. 3, page 188; A. R. R. 301; overruling B. 35-20-1170; O. D. 649. While this ruling appears to conflict with an earlier opinion of the Solicitor appearing in C. B. 2, page 149; S. 1246, no specific reference is made to this opinion.

earthquake and tidal wave;[4] a committee constituted by law which has control of funds to be used for the pensioning of members of a municipal police force;[5] an association organized and operated exclusively for the purpose of giving musical concerts, the programs being of an educational character, and no part of the net earnings under its charter inuring to the benefit of any private stockholder or individual;[6] a board of education of a school district which has been incorporated by the laws of a state;[7] and the Council of National Defense which was established by the Army Appropriation Act of August 29, 1916.[8]

The Treasury has also held that pew rents and so-called assessments and dues paid to churches[9] and a contribution of money toward the cost of an article presented by the contributors to a corporation organized exclusively for educational purposes, are deductible.[10]

Treasury's rulings holding gifts not deductible.—Donations, however, to the following organizations have been held not to be deductible within the 15 per cent limitation provided by section 214 (a-11): a family cemetery corporation organized under the laws of the state of New York;[11] a public high school, if the funds were to be used for athletic purposes;[12] a memorial fund established, not to engage in a charitable undertaking itself, but which distributes its income to charitable institutions and to worthy individuals;[13] and contributions to make good the deficit of a club engaged in recreational as well as educational activities;[14] the National Dry

[4] C. B. 1, page 151; O. D. 345.
[5] C. B. 1, page 148; S. 1202.
[6] C. B. 1, page 147; S. 1176.
[7] C. B. 1, page 146; S. 1052.
[8] C. B. 1, page 145; S. 992.
[9] C. B. 1, page 150; A. R. M. 2.
[10] C. B. 2, page 152; O. D. 465.
[11] C. B. 1, page 151; O. D. 217.
[12] C. B. 1, page 151; O. D. 126.
[13] C. B. 4, page 264; O. D. 872.
[14] C. B. 4, page 203; A. R. R. 379.

Federation;[15] an association engaged in disseminating propaganda to encourage the passage of labor legislation.[16]

The Treasury has also held that contributions by citizens of a city to a fund raised for the purpose of inducing an industrial plant to establish itself in their city,[17] and contributions to a trust company (a corporation) in trust to invest and disburse them for a charitable purpose are not allowable deductions under section 214 (a-11).[18]

Premiums on life insurance policy deductible as a gift—when?—

RULING. Premiums paid on a life insurance policy are allowable deductions from gross income when the beneficiary is a charitable corporation exempt from tax, provided the beneficiary named can not be changed at the option of the insured and the sum of the annual premium plus other allowable charitable contributions does not exceed 15 per cent of the taxpayer's net income. (C. B. 1, page 151; O. D. 299.)

Pledges—when deductible.—The deduction evidently is limited to contributions "made" and does not include subscriptions or promises to pay in the future. A subscription may constitute a legal liability and properly so appear among other accrued and unpaid liabilities; but a reasonable interpretation of the law seems to be that contributions which are "made" are strictly limited to those which have been paid in property, cash or notes, or other evidences of debt which the beneficiaries can reasonably convert into cash or hold as a suitable investment.

Procedure in reporting gifts.—

REGULATION. . . . . In connection with claims for this deduction there shall be stated on returns of income the name and address of each organization to which a gift was made and the approximate date and the amount of the gift in each case. . . . . (Art. 251.)

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[15] C. B. 1, page 150; O. D. 44.
[16] C. B. 2, page 162; S. 1362.
[17] C. B. 1, page 150; O. D. 39.
[18] C. B. 1, page 187; O. D. 669.

Under the law much is left to the good faith of the taxpayer. It is not enough, however, to make a wild guess at one's total contributions for the year. An accurate record must be kept to form a basis for the report required by the regulations. If this is done, such gifts as plate collections will be permitted.

Rule for valuing gifts.—

REGULATION. . . . . Where the gift is other than money the basis for calculation of the amount of the gift shall be the cost of the property, if acquired after February 28, 1913, or its fair market value as of March 1, 1913, if acquired prior thereto, after deducting from such cost or value the amount of depreciation sustained and allowable as a deduction in computing net income. . . .[19] (Art. 251.)

The foregoing regulation places the valuation of gifts on a proper basis. The provision regarding depreciation would seem to mean that if a taxpayer donates an office building which cost $100,000 in 1916 and no depreciation has subsequently been claimed (as it could have been) and the depreciated value at date of gift is $80,000, the latter amount is to be used as a deduction. If a residence which cost $100,000 in 1916 is donated, credit may be taken for $100,000, because depreciation since 1916 could not have been deducted.

If the foregoing is a correct inference the author doubts the validity of permitting deductions exceeding in amount the value of the property donated at the date of gift.

Individual credits for partnership gifts.—Gifts, such as contributions to the Red Cross, are not deductible by corpora-

[19] **[Former Procedure]** In an early edition of Regulations 45, this sentence of the article read as follows:

"Where the gift is other than money, the basis for calculation of the amount of the gift shall be the fair market value of the property at the time given."

As was pointed out in the 1920 edition of this book, the foregoing ruling permitted allowable deductions in excess of an equitable allowance. For a detailed criticism of this article as it originally appeared, see *Income Tax Procedure,* 1920, pages 560-562.

tions for either income or excess profits tax purposes.[20] In the case of the partnership, however, donations not deductible as business expenses "may be prorated among the individual members of the partnership for the purpose of their individual income tax returns, as contributions or gifts," subject to the 15 per cent limitation.[21]

Article 251 specifically provides for deduction by partners:

REGULATION. . . . . The proportionate share of contributions made by a partnership may be claimed as deductions in the personal returns of the partners to an amount which, added to the amount of such contributions made by the partner individually, is not in excess of 15 per cent of the partner's net income computed without the benefit of the deduction for such contributions; but the contributions made by the partnership shall not be deducted from its gross income in ascertaining the amount of its net income to be reported on Form 1065. . . . . (Art. 251.)

The distinction between gifts and business expenses.—

SO-CALLED GIFTS OFTEN BUSINESS EXPENSES.—It has been pointed out that for the most part expenditures termed "Christmas gifts" are, as a matter of fact, merely remuneration to the employee and properly deductible as a business expense to the employer. The same thing may be said of many payments variously characterized as gifts, donations, gratuities,[22] sub-

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[20] **[Former Procedure]** The author has always contended that partnerships were permitted under the 1917 law to deduct contributions, since section 206 of the 1917 law provided that "there shall be allowed (a) in the case of a domestic partnership the same deductions as allowed to individuals in subdivision (a) of section 5." The deduction resulted in a considerable saving in excess profits tax. The Treasury formerly disallowed 1917 contributions by partnerships, but the author's contention has been upheld by the Committee on Appeals and Review in B. 45-21-1914.

[21] Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated May 23, 1918.

[22] A gratuity is a free gift, voluntarily given, for which the giver receives no valuable or legal consideration. . . . It is not a charge against profits or surplus because it is not an expense or loss incurred in the operations, transactions, management or administration of a business. The giver acquires absolutely nothing; he does not liquidate a liability. The giving of it merely causes a depletion of assets resulting from a withdrawal of undivided profits or surplus.

"Possibly under peculiar conditions the giver receives consideration in the nature of advertising. In such a case it is correct to consider the disbursement a charge against advertising, but it should not be called a gratuity." (Joseph Robinson, *Journal of Accountancy*, November, 1918.)

scriptions, contributions, etc. In the past little attempt has been made to distinguish one class of payment from another. Certainly most payments so designated have not been distributions of profit in the usual and accepted meaning of that term. Almost without exception such items are charged to some expense account and are treated as ordinary and necessary expenses of doing business.

The Treasury's attitude toward the question of the deductibility of such items is shown in the following regulation:

> Regulation. Corporations are not entitled to deduct from gross income charitable or other contributions which individuals may deduct under paragraph (11) of section 214 (a). Donations made by a corporation for purposes connected with the operation of its business, however, when limited to charitable institutions, hospitals, or educational institutions conducted for the benefit of its employees or their dependents, are a proper deduction as ordinary and necessary expenses. Donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions from gross income. For example, a street railway corporation may donate a sum of money to an organization intending to hold a convention in the city in which it operates, with the reasonable expectation that the holding of such convention will augment its income through a greater number of people using the cars. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income. (Art. 562.)

The first sentence of the foregoing article is new.

This regulation is in one particular even more rigid than those which were in force some time ago. Under it, donations to be deductible must legitimately represent expenditure for a benefit "flowing directly to the corporation." T. D. 2090, in force until 1918, used the language "flowing directly or indirecly to the corporation." The example of the street railway donation, however, indicates that the Treasury may be willing to allow deductions for expenditures made in the hope or expectation that they will cause some benefit to flow "directly to the corporation." The attitude of the Treasury in the past

has seemed to exclude all expenditures which did not actually result in a "consideration moving in some form" to the corporation.[23] The distinction between an expenditure which was allowable and one which was not turned apparently on the result of such payment rather than on the intention of the payer. Business, of course, could not be conducted on these principles, because vast expenditures must often be made in the expectation that due consideration will "move" to those who pay the money—but it does not always move.

A "bank" donated a certain amount through a chamber of commerce for the purpose of inducing a railroad company to extend its tracks into the town in which it is located. It was held that the donation does not constitute an allowable deduction because "donations of the character stated are not ordinary and necessary expenses incident to carrying on a banking business" and that there is no "consideration for a benefit flowing directly to the contributing banks."[24]

It is to be hoped that the courts will at an early date pass upon the distinction between expenses which taxpayers think are proper and those which are held by the Treasury to be gifts without consideration. The Treasury in its attitude attacks the good faith and judgment of corporate directors. It is not likely that the courts will take a similar attitude.

Let the taxpayer ask himself this question: "Was the expenditure made to further my business interests?" If it can be answered in the affirmative, it is an allowable deduction as intended by the law.

This whole question is relatively unimportant, but the author has seen personally, and has heard of, so many cases where the only criticisms which have been made by income tax inspectors have concerned items of this nature that it seems desirable to dwell upon it at some length. Business men who are trying to be honest with the government do not like to be told that they erroneously included donations among their ex-

[23] T. D. 2090, December 14, 1914.
[24] I-3-35; I. T. 1169.

penses, and that these donations were distributions of profit. The taxpayer knows that they were not. They are, he considers, properly to be classified as necessary expenses, and he is justly annoyed.

The author suggests the abandonment of all these terms (gifts, donations, subscriptions, contributions, etc.) in books of account. Instead, open a new account, "Payments out of profits not deductible in income tax return." Charge to this account all items which are *actually* gifts, distributions of profit —that is, where there is no consideration moving in some form to the payer. Then in the regular expense accounts include all payments which are made in the regular order of the business for the good of business, and do not call them gifts, but describe them properly. If this is done, it is not likely that any inspector will criticize the distribution so long as it is made in good faith and without intent to evade the just tax.[25]

Donations by corporations.[26]—

Article 562, which is largely a repetition of former regulations, states that "donations which legitimately represent

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[25] **[British Practice]** In Great Britain "donations," technically speaking, are not deductible. But payments in the nature of donations are sometimes deductible. For instance, "where . . . . subscriptions are paid by a manufacturer to an infirmary—where any of his work people *might* be sent if injured—such subscriptions are allowable as a deduction, the payment being looked upon as a trade expense." (Murray and Carter, *A Guide to Income Tax Practice* (8th edition), page 155). When no direct benefit can be read into the subscriptions, they are regarded as disposals of profit and are not deductible.

[26] **[Former Procedure]**

Regulation. . . . . Expenses incurred in advertising and promoting the sale of Liberty bonds and war savings stamps over the corporation's name are deductible. . . . . (Reg. 45, Art. 562.)

Ruling. Where a corporation in order to promote the sale of war savings stamps to its employees donates a thrift stamp with each war savings stamp purchased, the amount expended by the corporation in purchasing the stamps so donated is an expense incurred in advertising and promoting the sale of war savings stamps over the name of the corporation and hence deductible from gross income under the provisions of article 562 of Regulations 45. (C. B. 3, page 266; O. D. 682.)

The provision that the expenses for promoting the sale of Liberty bonds are deductible expenses was hardly in line with the Treasury's attitude in the past.

a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions from gross income." It must be assumed, therefore, that expenses incurred in advertising the sale of Liberty bonds heretofore permitted as a deduction entail some measure of benefit flowing to the corporation. At the same time the regulations do not permit as deductions gifts to the Red Cross, Y. M. C. A., or other similar purposes.

RULING. Donations made by a corporation to a Young Men's Christian Association located on its property and operated for the benefit of the employees of such corporation are not deductible as ordinary and necessary business expenses. (B. Digest 31-21-1757; O. D. 986.)

If benefits running to the corporation can be identified with gifts such as those mentioned in the foregoing ruling, the deductions should be allowed as "necessary" expenses.

RULING. Even though the entire stock of a corporation is owned within a single family, such corporation is not entitled under the provisions of the Revenue Act of 1918 to deduct from gross income donations made to the American Red Cross, United War Workers, Liberty loan drives, or the Salvation Army. (C. B. 4, page 291; A. R. R. 373.)

It would seem that a corporation would reap quite as much benefit by making a contribution to the Red Cross as if it spent a large amount of money in advertising Liberty bonds. In the opinion of the author, Congress did not intend that a corporation should be permitted to deduct donations such as are mentioned above, and it cannot be expected that the law will be so administered. The allowance for Liberty bond expenses is probably a matter of expediency rather than a change in policy.

It has been stated that when a taxpayer sent a cheque to federal reserve banks or elsewhere to pay part or all of a charge for advertising Liberty bonds and the advertisement failed to mention the donor's name, the amount expended has been disallowed. The author is of the opinion that, if there is any warrant at all in the law for the expense, the advertiser

whose name did not appear can claim the deduction as a necessary business expense to the same extent as if the name appeared.

Donations to Red Cross and other war activities.—The question as to the deductibility, by corporations, of donations to the Red Cross has arisen so often that the Treasury in a lengthy decision reiterated its position that such contributions are not deductible.[27]

During 1921, reference has again been made to this subject in the following:

Ruling. In order to obviate the necessity of filing amended returns on the prescribed forms for the year 1918, corporations which, prior to the issuance of Treasury Decision 2847, filed their completed returns and erroneously claimed therein deductions on account of contributions to the Red Cross and other recognized war organizations, are required to file with the Collector of Internal Revenue within 30 days from the date of this decision a supplemental return in the form of a statement under oath showing the amount of such deductions claimed, the amount of net income as reported and as corrected, and the amount of additional tax due. Payment of the total amount of additional tax shown to be due by such supplemental return must also be made within 30 days.

In cases where this procedure is followed, formal amended returns will not be required and the supplemental returns referred to when received by this office through the collector's office will be filed with the original returns.

Where in connection with any return for the year 1918 an audit of the books of the corporation has been made by the Department and the amount of such contributions disclosed, the statement herein provided for need not be made.

Failure by a corporation to file a supplemental return as required will subject it to the penalties provided by section 3176, United States Revised Statutes. (B. 36-21-1807; T. D. 3215.)

Donations by agricultural corporations to fairs, etc.—

Ruling. A corporation engaged in agricultural business cannot be allowed to make a deduction from gross income on account of donations to fairs, churches and associations, such donations being

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[27] For text of regulation, see *Income Tax Procedure*, 1920, pages 566-567.

made for the purpose of obtaining and preserving the goodwill of the farmers who raise crops for it, since the amounts so expended are clearly in the nature of gratuities and are not necessary expenses of operation and maintenance, as there is no such consideration in this case as is contemplated in T. D. 2090. (Letter from Acting Commissioner of Internal Revenue, June 25, 1914.)

If followed literally, this decision would deprive some corporations of the right to claim advertising as an allowable deduction. Many public service corporations advertise to retain customers' goodwill rather than to seek new business.

Fortunately for corporations, questions as to what are and are not expenses necessary to obtain and retain the goodwill of customers will not be ultimately decided by the Commissioner of Internal Revenue but by the courts. Until such decision, corporations should continue to deduct all those expenses necessary properly to maintain their businesses. This, in the opinion of the author, is in accordance with the law and with common sense.

"Treating money" an expense, not a gift.—

Regulation. So-called "spending or treating money" actually advanced by corporations to their traveling salesmen, to be used by them as a part of the expense incident to selling the product of such corporations, is an allowable deduction in a return of income by such corporation. The deduction of such expenditures is conditioned upon a satisfactory showing that all the allowance claimed as a deduction was actually expended for and was an ordinary and usual expense incurred in selling the product or merchandise of the corporation. (Reg. 33, 1918, Art. 133.)[28]

Gifts of merchandise.—Probably every retailer is requested to make gifts to charitable and religious organizations. Usually the solicitor is a good customer and the donation is made. The author has never heard it seriously contended that gifts of this nature were other than expenses of doing business, as, of course, they are; and they should be so treated in preparing income tax returns. The Treasury in a certain

[28] T. D. 2090, December 14, 1914.

case ruled that they are not allowable deductions. Corporations, as a rule, do not make payments representing "mere gratuities," but expect and receive some consideration for expenditures of a quasi-charitable nature. As soon as the courts pass on the word "expenses" as used in the law, all items of this nature will no doubt be found to be deductible.

PART IV

SPECIAL CLASSES OF TAXPAYERS

CHAPTER XXXV

TAX ON UNDISTRIBUTED PROFITS OF CORPORATIONS

Congress has adopted two methods in the course of its attempts to prevent corporations from defeating the purpose of the income tax laws by the simple device of refraining from distributing their earnings. Until the earnings have been distributed as dividends and, consequently, have become subject to the surtax rates in the hands of the individual stockholders the demands of the tax have not been fully met. The first method of forcing distributions in cases in which they are deliberately withheld makes the entire profits "taxable to individual stockholders" and is directed at holding companies or "close" corporations which may refrain from distributing earnings because corporations are not subject to the surtax imposed upon individuals. An attempt is made to tax the individual stockholder as if the earnings were actually distributed, thus collecting the surtax. This method under the 1913, 1916 and 1918 laws failed in its object. It is rumored that the tax has been imposed in a few cases. The author has been unable to learn the details of a single case.

The second method levies an additional tax on undistributed earnings. It does not attempt to collect a surtax from stockholders, but imposes an additional flat rate tax on the corporation itself. The 1917 law which imposed this tax may be said to have been a failure.[1] The 1921 law may be more successful.

[1] **[Former Procedure]** Every time the question of a new tax on undistributed profits arises, apprehension is felt that *prior* or *accumulated* surplus is to be taxed. In the opinion of the author there is and has been no justification for such apprehension.

In 1917, when the 1916 law was being amended, Senator Jones proposed

Evasion of surtaxes by incorporation.—

LAW. Section 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalities, as that tax: *Provided*, That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for

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an amendment imposing an additional tax of 15 per cent on all surplus *of the taxable year* undistributed sixty days after the end of the taxable year. There was no thought of retroactively taxing accumulated surplus of prior years. When the amendment was proposed every member of the Finance Committee, but one, voted for it. (*Congressional Record*, September 10, 1917, page 7409.) Subsequently they voted against it and the amendment was not adopted.

For text of previous laws and full discussion thereof, see *Income Tax Procedure*, 1919, pages 617-624; and 1920, pages 963-974. What has occurred in the past is only of academic interest.

The Treasury admitted that section 220 of the 1918 law was difficult to administer. In *Notes on the Revenue Act of 1918*, the Secretary of the Treasury said:

"The corporate form of organization is now used or abused by wealthy individuals who incorporate their personal business and investments and thus escape surtaxes upon that amount of their income which is reinvested or saved. Section 220 provides a remedy for this abuse, but it can be applied only by a troublesome special procedure which will necessarily restrict its use to a comparatively small proportion of cases."

In the stock dividend case (*Eisner v. Macomber*, 252 U. S. 189), the Supreme Court decided in effect that under an income tax law, stockholders could not be taxed unless they received or realized actual income. The 1918 law attempted to impose a tax upon individual stockholders, not upon corporations. The tax would be levied against stockholders on earnings *not* distributed and would therefore appear to be unconstitutional. The author does not know of any case in which such an assessment has been made, and as the Treasury since the stock dividend decision is in doubt about the legality of the section, the practical effect of the 1918 law does not seem to be serious.

the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

REGULATION. Where a domestic or foreign corporation permits its gains and profits to accumulate for the purpose of preventing the imposition of the surtax upon such income if distributed to its stockholders, it shall be subject to an income tax at 25 per cent in addition to the taxes imposed by section 230 of the statute. If, however, all the stockholders agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax them upon their distributive shares in the net income of the corporation for the taxable year as provided in subdivision (a) of section 218, in the case of members of a partnership. In any case the Commissioner or a collector may require a corporation to furnish a statement of its gains and profits and of the names, addresses, and shareholding of the stockholders, and of the amounts that would be payable to each. (Art. 351.)

Accumulation of earnings to be taxable must be with purpose of evasion.—

REGULATION. Section 220 of the statute applies where a corporation is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members by permitting its gains and profits to accumulate instead of being divided or distributed. Prima facie evidence of a purpose to escape the surtax exists where a corporation has practically no business except holding stocks, securities or other property and collecting the income therefrom, or where a corporation other than a mere holding company permits its gains and profits to accumulate beyond the reasonable needs of the business. The business of a corporation is not limited to that which it has previously carried on, but in general includes any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape

the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business. (Art 352.)

A corporation could pay off all its debts, add to its plant and inventories, expand in similar ways and retain substantial cash working capital without being subject to tax upon its undistributed earnings.

Accumulation of earnings to be taxable must be unreasonable in amount.—

Regulation. An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. (Art. 353.)

When investment companies, such as those formed by individuals and estates, invest their surplus funds in marketable securities, such as Liberty bonds, and do not pay reasonable cash dividends, an intention to relieve stockholders from surtax may be inferred. When the investments are in the

securities of closely held corporations, in real estate or other property which is not readily marketable, *and* when it is necessary similarly to reinvest the accruing surplus in the same properties, the element of evasion is palpably absent. The section became effective November 23, 1921, and does not affect surplus or earnings accumulated prior to that date. Penalty sections, unlike others, never take effect retroactively.

If prior to November 23, 1921, surplus was available and was not distributed, the penalties for failure to distribute are found in the abortive provision of the 1918 law. It can hardly be held that the 1921 law has any retroactive effect. Penalty sections cannot be enforced until after due notice has been given.

In all cases where no good reason exists for the accumulation of earnings subsequent to November 23, 1921, dividends corresponding closely to the realized earnings should be declared.

It is fortunate for corporations that the word "reasonable" is in the law. A corporation may refrain from distributing its profits, even if it has no debts, if there is a reasonable present need for the profits in the business or a prospective need within the reasonably near future. Conservative corporations accumulate large cash surplus whenever a profitable year enables them to do so. The courts will not hold that distributions should be made to stockholders, if the directors in good faith and after due consideration decide that the present or prospective needs of the business itself (which must be paramount) do not justify larger cash dividends than are being paid.

Stockholders of properly conducted corporations need not be any more disturbed over the new law than over the old. However, if accumulated earnings remain undistributed solely to permit stockholders to escape the surtax, that purpose should be frustrated. The continued attempts of Congress and of the Treasury to formulate means of forcing distributions indicate that an attempt will be made to enforce the present law.

Ruling. The question as to the unreasonable accumulation of undivided profits is one of fact to be decided upon a consideration of the volume of business done and the principles of sound business management. The fact that a corporation having capital stock of 10x dollars and doing an annual business in excess of 150x dollars has an accumulation of 55x dollars in undivided profits is not sufficient basis for finding that there has been an unreasonable accumulation of profits. (C. B. 1, page 182; S. 1117.)

Investment of accumulation in obligations of the United States no bar to action.—The test of ability to distribute lies in the form of the assets. Investments in Liberty bonds, when no liabilities present or prospective exist, constitute *prima facie* evidence of ability to distribute.

Retirement of preferred stock.—The retirement or purchase of preferred stock would be a proper use of surplus earnings and would not be deemed to be a method of preventing the imposition of the surtax.[2]

Reduction of common stock.—The purchase of common stock for the treasury or the retirement of common stock, with a consequent reduction of the aggregate stock outstanding or a reduction of the par value of each share, cannot in itself be deemed to be a method of preventing the imposition of the surtax. But if the common stock were purchased *pro rata* from stockholders at a large premium, it might be held that such purchase is in effect a distribution of surplus. If the surplus earned since March 1, 1913, had not been distributed, it could hardly be claimed that the premium paid on the common stock is a distribution of capital surplus or surplus accumulated prior to March 1, 1913.

There may be exceptional cases in which the retirement

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[2] [Former Procedure] A ruling which directly related to this point was rendered under the 1916 law:

Regulation. . . . . (a) The earnings of a corporation used to purchase preferred stock for cancellation are retained for employment in the reasonable requirements of the business, and are therefore not taxable. (T. D. 2570, November 6, 1917.)

of common stock would be deemed to be *prima facie* evidence that earnings were unlawfully accumulating.

RULING. . . . . Inasmuch as a retirement of capital stock would indicate that additional capital was not required, any retirement of common stock, leaving the surplus stand, would be regarded by this office as making the corporation one coming within the provisions of Section 220 of the Revenue Act of 1918. (C. B. 2, page 25; O. D. 360.)

Can proceeds of sale of capital assets be reinvested without subjecting stockholders to surtax?—Article 352 states that "a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax."

Many corporations sell all or part of their capital assets and receive in payment cash or marketable securities. The question arises, whether or not a corporation may invest or reinvest the proceeds of sale without subjecting the corporation to the 25 per cent tax. If a corporation is in the automobile manufacturing business or holds stocks in other corporations which are in that business and sells its manufacturing business or capital stocks for cash, and soon thereafter reinvests the proceeds in other automobile stocks or resumes the manufacture of automobiles, such transactions do not constitute a radical change of business and its stockholders could not be taxed. If the corporation sells its assets and purchases general investment securities with the proceeds, such procedure involves a radical change in the business and it could hardly be maintained that the accumulated surplus is held for the "reasonable needs of the business." On the contrary it would be difficult to argue that a former manufacturing corporation with a large surplus, no assets except marketable securities and no debts, requires any surplus whatever.

It is contrary to ordinary commercial methods for a business corporation to transform itself into an investment corporation. When stockholders invest in manufacturing or trading corporations they hazard their money and expect returns com-

mensurate with the risks of the business. Stock in a bank or trust company usually is looked upon as less of a risk. Purchases of one or the other are made, but the author has never heard of an original purchase of one class of stock by a purchaser who expected that the corporation would transform itself into a concern of an entirely different kind. When a corporation does transform itself, a *prima facie* case is made out for the imposition of the 25 per cent tax.

If corporation sells capital assets or accumulates funds in excess of its needs, how much of surplus must be divided?— If it is obvious or if it is admitted by a corporation that cash or marketable securities in hand are in excess of the needs of the business, the question arises as to what part of the accumulated surplus must be distributed. Ordinarily it cannot be assumed that the earnings of a current fiscal period can be segregated to any part of the period. Surplus earnings accumulated during the taxable year 1922, which are known to be available as soon as realization takes place, fall within the purview of the law. But the 1921 law can reach only unlawful accumulations. Surplus which originated prior to November 23, 1921, if lawfully accumulated, cannot be taxed at the 25 per cent penalty rate. If unlawfully accumulated it must be taxed, if at all, under the penalty clauses contained in the 1913-1918 laws.

The Treasury held that the 1918 law did not apply to surplus accumulated prior to January 1, 1918; that if any surplus was improperly accumulated prior to that date, the laws in force during the prior period are applicable thereto.

Prior to November 23, 1921, unlawful accumulations could be taxed only as if the stockholders were partners.

The attitude of the Treasury in enforcing the penalty clauses in former laws is fully set forth in one case[3] in which the Secretary of the Treasury had certified that the undis-

[3] C. B. 4, page 227; A. R. R. 475.

tributed accumulations of profits were unreasonable. Upon appeal the following opinion was handed down:

RULING. The taxpayer contends that this is not a case where section 2 (A) 2 of the 1913 Act, section (3) of the 1916 Act and section (3) of the 1916 Act as amended, and section 220 of the 1918 Act should be applied, for the reason that the M Company was not a mere holding company and did not permit its gains and profits to accumulate beyond the reasonable needs of the business.

In the ordinary and accepted sense, the term "holding company" means one which is not actively engaged in business and which does nothing but hold stock of other corporations. The M Company has been actively engaged in business since its organization and has consistently paid capital stock taxes. It is noted that the 1913 Act, quoted above, requires that the corporation must be formed for the purpose of preventing the imposition of the tax through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, or must have been *fraudulently availed of* for that purpose before the Secretary of the Treasury is authorized to make the certification which has been made in this case.

An examination of the facts leading up to the organization of this corporation, the consideration of the rate of dividends paid, and the amounts carried to surplus from year to year do not indicate to the Committee that the corporation was *fraudulently availed of* for the purpose of preventing the imposition of the tax through the medium of permitting the gains and profits to accumulate instead of dividing or distributing such gains and profits.

Therefore the Committee recommends that the action of the Income Tax Unit in assessing additional taxes for the years 1913 to 1917, inclusive, was in error and that such action be reversed and that the claim filed for the refunding of taxes paid on account of such assessment receive favorable consideration.

The Committee has accepted the Bureau's position with respect to the reasonable requirements of a business as outlined in Treasury Decision 2736. Applying the principle therein laid down to the facts in the instant case, it would appear that all the capital of the M Company which is invested in the capital stock of the N Company or which is used in making loans and otherwise financing such subsidiary *is needed in the business* of such company. The facts now submitted are materially different from those submitted to the Secretary of the Treasury at the time the certification in question was made. Upon the basis of this additional evidence the present Secretary of the Treasury signed a resolution recalling the former certification in this case. The Committee is in full accord with this action. The effect of this resolution is to remove the presumption of fraud heretofore existing against the corporation.

It is strongly urged that any taxes assessable under the provisions of the revenue Acts quoted above are in the nature of a *penalty*, and in order that such assessment may properly be made *fraud or fraudulent intent* must be established. It is submitted in the instant case that the corporation in carrying to surplus a considerable part of its earnings yearly *is doing nothing more than was contemplated under the provisions of its charter.* It is also submitted that this corporation could not have been created for the purpose of permitting its earnings to accumulate, thereby preventing the imposition of tax on such earnings, for the reason that the corporation was organized in 1898. The mere fact that the corporation carried to surplus these earnings is not to be considered as a *fraud upon the Government,* bearing in mind always that the corporation is not a mere holding company, that it has considerable income from operations, rents, royalties, and from interest on money loaned and investments in bonds. The corporation has been conservative in carrying a considerable portion of its earnings to surplus, and the mere fact that such earnings were carried to surplus and that the corporation now has a large accumulated surplus does not of itself authorize the Income Tax Unit to assess a tax against the stockholders on their pro rata share of such earnings. The fact that the corporation increased its dividends and, having increased the dividends, continued to pay same even though the earnings of the corporation fluctuated from year to year, substantiates the view of the Committee that the corporation was not fraudulently availed of for the purpose of preventing the imposition of the tax through the medium of permitting the gains and profits to accumulate instead of distributing such gains and profits. . . . .

Election to be taxed as individuals.—The 1921 law provides that if *all* stockholders agree, the corporation may be relieved of "all income, war-profits and excess-profits taxes" and the stockholders as individuals shall be taxed upon their distributive shares. The only apparent excuse for such an agreement would be the definite knowledge that the 25 per cent penalty tax is to be enforced. In such cases stockholders should agree. But the contingency can hardly arise in a business corporation, and if it appears to arise in other cases the proper procedure is to distribute current earnings as they accumulate.

CHAPTER XXXVI

NON-RESIDENT ALIENS

The 1921 law[1] deals at greater length than prior laws with the determination of the gross income of non-resident aliens which is to be considered as income from sources within the United States.[2] What is so considered may be summarized as follows:

1. Interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise.[3]
2. Dividends from certain domestic and foreign corporations.[4]
3. Compensation for labor or personal services performed in the United States.
4. Rentals and royalties from United States sources.
5. Gains from sale of real property located in the United States.

While the foregoing represents what is generally taxable income to a non-resident alien, there are various items not subject to tax which are specifically dealt with hereafter in this chapter.[5] Of these exempt items, interest on deposits in banks located in the United States paid to persons not engaged in business within the United States is for the first time included in the 1921 law. Considerable objection has been raised heretofore concerning the taxation of this interest and its exemption now will be as popular as it is equitable. Another

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[1] Section 217 for individuals. Section 233 (b) makes the classification in section 217 also applicable to the gross income of foreign corporations, except foreign insurance companies subject to the tax imposed by sections 243 and 246.

[2] For former procedure, see *Income Tax Procedure*, 1921, page 975 *et seq.*

[3] For exception relative to interest, see page 1278.

[4] See page 1279.

[5] See page 1284.

new feature of the present statute is the exemption from taxation of interest received from a resident alien individual or foreign corporations where less than 20 per cent of the gross income of the payor has, for the preceding three years, been derived from sources within the United States.

From the taxable items constituting the gross income there may be deducted items of expense properly allocated to such income. Where the segregation of expenses against particular gains cannot be made, a proportionate part of the total expenses must be so allocated.

In drafting the new law, it was proposed to tax citizens or residents of the United States, domestic partnerships or domestic corporations, 80 per cent of whose gross income for the past three years was from sources without the United States, and 50 per cent of whose gross income for the past three years was from the active conduct of a business outside the United States, only on the income arising from sources within the United States as defined in section 217.

In place of this proposal, the new law limits the privilege to citizens of the United States and to domestic corporations.[6]

Method of collecting the tax.—The collection of the tax may be made through two channels:

1. Withholding of normal tax at source.
2. Requirement of returns direct from taxpayer.

Only in case (2) is a non-resident alien able to get the benefit of such deductions and credits as are allowed him by law, except that benefit of the $1,000 credit allowed by section

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[6] **[Former Procedure]** RULING. "A corporation organized in the United States is subject to the 4 per cent war income tax imposed by section 4 of Title I of the Revenue Act of 1917, even though it has its principal office, keeps its accounts, and does all of its business in Porto Rico and derives all of its income from sources therein. Such a corporation should file its return in the internal revenue district where its principal office in the United States is located.

"Law Opinion 303 (not in bulletin service) revoked." (C. B. 4, page 272; L. O. 1066.)

216 (e) may be obtained by filing claim with the withholding agent.

Definitions.—It is very important that taxpayers and those responsible for withholding appreciate the real significance of the following definitions.

LAW. Section 2. . . . (4) The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

(5) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia; . . . .

FOREIGN PARTNERSHIPS AND RESIDENT FOREIGN CORPORATIONS.—

REGULATION. . . . . The nationality or residence of members of a partnership does not affect its status. A partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership. A foreign corporation engaged in trade or business within the United States or having an office or place of business therein is sometimes referred to in the regulations as a resident foreign corporation and a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein as a nonresident foreign corporation. . . . . (Art. 1509.)

Non-resident alien individual.—

REGULATION. A "nonresident alien individual" means an individual (*a*) whose residence is not within the United States and (*b*) who is not a citizen of the United States. An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad

when the purpose for which he came has been consummated or abandoned. . . . . (Art. 311.)

Proof of residence of alien.—

Regulation. The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein within the meaning of the Revenue Act. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overthrown (1) in the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (a) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the Naturalization Laws, (b) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 or its equivalent, or (c) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States had been of such an extended nature as to constitute him a resident; (2) in other cases by (a) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien has filed Form 1078 or its equivalent, or (c) proof of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident. In any case in which an alien seeks to overcome the presumption of nonresidence under (1) (c) or (2) (c) above, if the officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts, require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits. (Art. 312; Reg. 45, Art. 313.)

Loss of residence by alien.—

Regulation. An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States. The status of an alien on the last day of his taxable year or period determines his liability to tax for such

year or period as a resident or nonresident. . . . . (Art. 313; Reg. 45, Art. 314.)

Determination of status of alien leaving the United States. —The status of an alien leaving the United States during the taxable year is determined by his status on the last day of his taxable period.

RULING. . . . . The taxable period is the interval between January 1 and the last day of the month preceding his departure. If the alien had formed no intention of leaving the United States by such date he will be taxed as a resident alien. If, however, his intention to depart was formed prior to the last day of the month preceding departure, he will be taxed as a nonresident alien for such period. In either case the alien is entitled to the full exemption and credit for dependents that he would have been entitled to had his return been filed for the full taxable year. If the absence of a resident alien is to be only temporary, he will not lose his status as resident by reason of such absence. (C. B. 2, page 243; O. D. 468.)

ALIEN SEAMAN—WHEN TO BE REGARDED AS RESIDENT.—

REGULATION. In order to determine whether an alien seaman is a resident within the meaning of the income-tax law, it is necessary to decide whether the presumption of nonresidence is overcome by facts showing that he has established a residence in the territorial United States, which consists of the States, the District of Columbia, and the Territories of Hawaii and Alaska, and excludes other places. Residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel flying the United States flag and engaged in foreign trade is not sufficient to establish residence in the United States, even though the vessel, while carrying on foreign trade, touches at American ports. An alien seaman may acquire an actual residence in the territorial United States within the rules laid down in article 312, although the nature of his calling requires him to be absent from the place where his residence is established for a long period. An alien seaman may acquire such a residence at a sailor's boarding house or hotel, but such a claim should be carefully scrutinized in order to make sure that such residence is bona fide. The filing of Form 1078 or taking out first-citizenship papers, is proof of residence in the United States from the time the form is filed or the papers taken out, unless rebutted by other evidence showing an intention to be a transient. The fact that a head tax has been paid on behalf of an alien seaman entering the United States is no evidence that he has acquired residence because the head tax is payable unless the alien who is entering the country is merely in transit through the country.

An alien may remain a nonresident although he is not in transit through the country. . . . . [Art. 311 (a).]

It is apparent from the foregoing regulations that residence for income tax purposes is a question both of intent and of fact. If an alien lives as long as one year within the United States, such fact is presumptive but not conclusive evidence as to residence.[7] Nevertheless, the pay-rolls of an employer may be accepted as written evidence of an employee's continuous residence in the United States, thereby establishing his status as a resident alien, unless the employer knows that the employee does not intend to remain here permanently.[8] A member of a foreign partnership who is within the territorial limits of the United States seven or eight months of the year does not become a resident if his presence here is to complete business for his firm and if when that is accomplished he returns abroad.[9] A non-resident alien who has served at least one year in the United States Army has been considered a resident for income tax purposes.[10] It is necessary for a widow who was a citizen before her marriage to a non-resident alien to register as an American citizen with a United States consul within one year after the death of her husband if she would become a citizen instead of a non-resident alien for tax purposes.[11] Members of the families of foreign ambassadors and attachés, secretaries and servants included in their suites, are held to have the status of non-resident aliens for tax purposes and are subject to taxation only as income from any business conducted by them in the United States.[12] Non-resident naturalized citizens who expatriate themselves but subsequently apply to an American consul for registration as American citizens, do not thereby become repatriated though their registration is accepted by the Department of State.[13]

[7] C. B. 1, page 164; O. D. 197.
[8] Treasury Bulletin "B," page 13.
[9] C. B. 3, page 128; O. D. 592.
[10] C. B. 1, page 163; O. D. 117.
[11] C. B. 2, page 59; O. D. 533.
[12] I-1-5; T. D. 3266.
[13] C. B. 4, page 59; O. D. 861.

Duty of employer to determine status of alien employee.—

REGULATION. If wages are paid to aliens without withholding the tax, except as permitted in article 315, the employer should be prepared to prove the status of the alien as provided in the foregoing articles. An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078 or an equivalent certificate of the alien establishing residence. An employer need not secure Form 1078 from the alien if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he had not at the time secured Form 1078 or its equivalent, is permitted to prove the former status of the alien by any competent evidence. The written statement of the alien employee may ordinarily be relied upon by the employer as proof that the alien is a resident of the United States. (Art. 314.)

Form 1078—"Certificate of alien claiming residence in the United States."—The presumption of non-residence is overcome by obtaining from the alien form 1078 (revised) or an equivalent certificate of alien claiming residence. Ordinarily this form should be executed before any officer duly authorized to administer oaths.

RULING. . . . . However, if such an officer is not reasonably accessible, it will be accepted if signed in the presence of an officer of the employer company under whose supervision the employee's duties are performed, and one other credible witness. If the withholding agent did not procure this form or its equivalent, at the time of payment, he may prove the former status of the alien by any material evidence. Execution of this form does not bind the alien to become a citizen or to reside here permanently. Furthermore, it will not be necessary to procure this certificate every taxable year. It is applicable to the year during which filed and subsequent years. The employer should keep a record of each Form 1078 filed. The forms should be sent to the Commissioner of Internal Revenue, Sorting Division, Washington, D. C., not later than the 20th of the month succeeding that during which the certificate was received. (Treasury Bulletin "B," page 14.)[14]

If form 1078 (revised) was not secured from an alien and the employer is required to account for failure to withhold tax in the past, the employer is permitted to submit pay-

[14] Pending further revision of form 1078 (revised January, 1920) information regarding length of employment and amount paid need not be supplied on this form. (B. 37-20 1104; O. D. 600.)

roll records as written evidence or proof of the status of the alien.[15]

Gross income defined.—The gross income of non-resident alien individuals[16] and foreign corporations[17] is covered by the following statutory provisions and regulations:

LAW. Section 213. . . . . **(c) In the case of a nonresident alien individual, gross income means only the gross income from sources within the United States, determined under the provisions of section 217.**

REGULATION. In the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States, determined under the provisions of section 217. . . . . As to the gross income of foreign corporations see section 233 (b) of the statute and article 550; also section 217. . . . . The items of gross income from sources without the United States and therefore not taxable to nonresident aliens or foreign corporations are described in section 217 (c) . . . . (Art. 92.)

The essential differences between the 1921 law and the statute of 1918[18] are contained in section 217 of the former, which is referred to in the foregoing regulation. In so far as income is concerned the material changes are the *exclusion* under specific conditions, of

[15] Treasury Bulletin "B," page 13; see also *Income Tax Procedure,* 1920, page 818.

[16] Members of foreign partnerships are taxed in their individual capacity upon their respective shares of income of the partnership from sources within the United States. However, withholding is now required. See page 1306.

[17] Under the Revenue Act of 1916 the Treasury ruled that foreign corporations, of the nature specified as being exempt from taxation, are in the tax-exempt class. There has been no subsequent ruling on this point, but the wording of the law would imply that such organizations are exempt from tax.

[18] **[Former Procedure]** The following definition of "gross income" obtained under the 1918 law:

REGULATION. "In the case of nonresident alien individuals 'gross income' means only the gross income from sources within the United States. This includes interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, amounts received representing profits on the manufacture or disposition of goods within the United States, rentals and royalties from property and income from business carried on in the United States, interest on deposits in banks located within the United States, income from capital otherwise invested in the United States, and income from services rendered or labor performed within the United States. . . . ." (Reg. 45, 1918, Art. 91.)

1. Interest on deposits with persons carrying on the banking business.
2. Interest received from resident alien individuals or resident foreign corporations when less than 20 per cent of the gross income of the payor, for the three preceding years, has been derived from sources within the United States.
3. Dividends from corporations entitled to the benefits of section 262.
4. Earnings derived from the operation of ships under circumstances defined in section 213 (b-8).

The changes in the nature of additional *inclusions* are:

1. Dividends from foreign corporations 50 per cent or more of whose gross income for the three years preceding the declaration of such dividend was derived from sources within the United States.
2. Gains, profits and income from the sale[19] of real property located in the United States.
3. Rentals and royalties are extended to embrace the use of, or privilege of using, in the United States, patents, copyrights, formulas, trademarks and other like property.

RULING. The profit derived by a nonresident alien author from the sale of all rights of serial publication in the United States in certain stories is not considered as income from a source within the United States and accordingly is not subject to withholding. (B. 32-21-1759; O. D. 988.)

LAW. Section 233. . . . . **(b) In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by section 243 or 246) in the manner provided in section 217.**

There is no difference in the computation of the gross in-

[19] LAW. Section 217. " . . . (f) As used in this section the words 'sale' or 'sold' include 'exchange' or 'exchanged'; and the word 'produced' includes 'created,' 'fabricated,' 'manufactured,' 'extracted,' 'processed,' 'cured,' or aged.' . . . . "

come of foreign corporations and non-resident alien individuals. Both are governed by section 217 of the statute.

REGULATION. The gross income of a foreign corporation, including a mutual insurance company, means its gross income from sources within the United States, as defined and described in section 217 and articles 316-328 relating to nonresident alien individuals. . . . . (Art. 550.)

Income of Non-resident Alien Individuals or of Citizens Entitled to Benefit of Section 262

Section 213 (c)[20] defines gross income as that determinable under section 217, which has two main divisions:

1. Income from sources within the United States, covered by subdivision (a).
2. Income from sources without the United States, covered by subdivision (c).

Income from sources within the United States.—

LAW. Section 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262 the following items of gross income shall be treated as income from sources within the United States: . . . .

INTEREST.—

LAW. Section 217. (a) . . . . **(1) Interest on bonds, notes,** or other interest-bearing obligations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable; . . . .

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[20] See page 1276.

Dividends.—

Law. Section 217. **(a) . . . . (2) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section; . . . .**

Dividends paid by resident corporations are included in gross income, but as they are allowed as a deduction under section 234 (a-6), no tax is payable thereon.

The following excerpt from the regulations covering the foregoing subsection of the law, calls attention to the necessity of the taxpayer proving that the income he reports hereunder falls within the meaning of the law.

Regulation. There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations and citizens of the United States or domestic corporations which are entitled to the benefits of section 262, all interest received or accrued, as the case may be, on bonds, notes, or other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except:

(a) Interest paid on deposits with persons, including individuals, partnerships, or corporations carrying on the banking business, to persons (nonresident alien individuals, foreign corporations and citizens of the United States, or domestic corporations entitled to the benefits of sec. 262) not engaged in business within the United States, and not having an office or place of business therein; and

(b) Interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per cent of the gross income of such resident payor has been derived from sources within the United States for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable.

Any taxpayer who excludes from gross income from sources within the United States income of the type specified in (a) or (b) above shall file with his return a statement setting forth the amount of such income and such information as may be necessary to show that the income is of the type specified in those paragraphs. (Art. 317.)

Compensation.—

Law. Section 217. (a) . . . . (3) **Compensation for labor or personal services performed in the United States; . . . .**

Regulation. Gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for services was made, or of the place of payment. When a specific amount is paid for labor or personal services performed in the United States, such amount shall be included in the gross income. When no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i. e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. (Art. 319.)

Rentals and royalties.—

Law. Section 217. (a) . . . . (4) **Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; . . . .**

Sale of real property.—

Law. Section 217. (a) . . . . (5) **Gains, profits, and income from the sale of real property located in the United States. . . . .**

Regulation. . . . . (c) A nonresident alien individual, or a citizen entitled to the benefits of section 262 may elect to be taxed under section 206 with respect to sales or exchanges of property located within the United States, subject to the limitation that his total tax may not be less than 12½ per cent of his total net income from sources within the United States. (Art. 1651.)

For the treatment of capital net gain, see full discussion of the subject in Chapter XVII.

Only non-resident alien individuals are interested in whether or not profits from sale of property are to be taxed as a "capital gain," as the rate of tax on the income of cor-

porations (both foreign and domestic) and the rate of tax on capital gains are identical, viz., 12½ per cent.

Other income from sources within the United States.—

Regulation. Items of gross income other than those specified in section 217 (a) and (c) and articles 317-323 shall be allocated or apportioned to sources within or without the United States, as provided in subdivision (e) of section 217.

The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in article 327.

Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. (Art. 326.)

Income from sources without the United States.—The law merely defines in section 217 (c) (1-5), income from sources without the United States as being income which is other than that provided for in the subsections (1) to (5) of section 217 (a) quoted above.

Income from sources both within and without the United States.—

Law. Section 217. . . . . (e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income

therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold. . . . .

Regulation. Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold. The word "sold" includes "exchanged" and ordinarily means the place where marketed. This article does not apply to income from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States or produced (in whole or in part) by the taxpayer without and sold within the United States. . . . . (Art. 323.)

The following article of the new regulations gives certain rules for the allocation of income derived from sources partly within and partly without the United States by manufacturers and producers.

Regulation. . . . . *Manufacturers and producers.*—Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced in whole or in part by the taxpayer without and sold within the United States shall be treated as derived partly from sources within and partly from sources without the United States, under one of the cases named below. As used herein, the word "produced" includes

created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1: Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country than that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return.

Case 2: Where an independent factory or production price has not been established as provided under case 1, the net income shall first be computed by deducting from the gross income derived from sources partly within and partly without the United States the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within and without the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States and the denominator of which consists of the value of the taxpayer's property both within and without the United States. The remaining one-half of such net income shall be apportioned in accordance with the gross sales of the taxpayer within and without the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within and without the United States. "Gross sales within the United States" means the aggregate amount of all sales made during the taxable year which were principally secured, negotiated or effected by employees, agents, offices, or branches of the taxpayer's business resident or located in the United States.

The term "property" as used in this article includes only the

property held or used to produce income which is derived from sources partly within and partly without the United States (excluding all property held or used to produce income which is allocated or apportioned under other articles or paragraphs of these regulations). Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of the Revenue Act of 1921 shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period, such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch or agent in the United States.

Case 3: Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas prescribed under cases 1 and 2, the income derived from sources within the United States. (Art. 327.)

Computation of tax where income is from sources within and without the United States.—

Regulation. Where a taxpayer has gross income from sources within or without the United States as defined by section 217 (a) or (c) together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto shall be segregated, and the net income from sources within the United States shall be separately computed therefrom. (Art. 328.)

What is excluded from gross income?—The general principle underlying section 217 of the 1921 law is that income which non-resident aliens (whether individuals or corporations) derive from sources within the United States shall be

subjected to the same income taxes which have to be paid on similar income received by residents or domestic corporations in the United States. There is, however, certain income which is exempt when received by non-resident aliens, some of it because it is exempt regardless of by whom received and some of it because of specific provisions of law applicable only to non-resident aliens or foreign governments.

INCOME GENERALLY EXEMPT.—Interest from state and municipal bonds, farm loan bonds, property acquired by gift,[21] devise, bequest or descent, proceeds of life insurance paid to an individual upon death of the insured, and similar items expressly stated by law to be exempt from tax when received by a resident, are also exempt when paid to a non-resident alien.

INCOME FROM UNITED STATES BONDS TAX EXEMPT[22] AFTER MARCH 3, 1919.—

REGULATION. By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919, amending section 3 of the Fourth Liberty Bond Act of July 9, 1918, the interest received on and after March 3, 1919, on bonds, notes and certificates of indebtedness of the United States and bonds of the War Finance Corporation, while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, not engaged in business in the United States, is exempt from all income and war-profits and excess-profits taxes. (Art. 94.)

This regulation was numbered 93 in the 1918 regulations.

INCOME OF FOREIGN GOVERNMENTS.—

REGULATION. The exemption of income of foreign Governments applies also to their political subdivisions. Any income collected by foreign Governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign Governments, is subject to tax. The income from investments in the United States in bonds and stocks and from interest on bank balances received by ambassadors and ministers accredited to the United States and the fees of foreign

[21] Subject to limitation of section 202 (a 2). See page 619.
[22] See Chapter XX.

consuls are exempt from tax, but income of such foreign officials from any business carried on by them in the United States would be taxable.[23] . . . . (Art. 86.)

Operation of ships, when earnings are not included in gross income.—Under section 213 (b-8) non-resident alien or foreign corporations are not called upon to include in their gross income earnings derived from the operation of ships under conditions specified in the following regulation.

Regulation. The following additional exclusions from gross income not provided by the Revenue Act of 1918 are allowed by the Revenue Act of 1921:

(1) Income of a nonresident alien or foreign corporation consisting exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and corporations organized in the United States. Any taxpayer claiming this exemption must file, under oath, a statement citing the foreign statute which grants the equivalent exemption and stating fully the facts upon which he relies to establish his claim; . . . . (Art. 89.)

Rulings regarding income from sources within the United States.—While it is difficult to determine from the law and regulations exactly what constitutes income from sources within the United States, certain items of income have been expressly construed by the Treasury as taxable or non-taxable.

Ruling. Where bonds, notes, or other obligations of a foreign Government are underwritten by a United States banking establishment and are by their terms payable at an office of such banking establishment in the United States, interest paid from the United States office to nonresident alien individuals or foreign corporations who are holders of such securities is not to be regarded as income received from a source within the United States. (C. B. 1, page 99; O. 786.)

Profits on exchange realized on such payments are held to be non-taxable because not realized from sources within the

[23] "Income from sources within the United States received by a foreign ruler in his individual capacity is subject to income tax. Income received by him from property belonging to the Crown is not." C. B. 2, page 96; O. D. 483.)

United States.[24] The identity of interest on such securities is lost if the amount collected is credited to an account in a domestic bank and interest is allowed on such balances. Under this condition the interest becomes subject to tax.[25] The following ruling regarding discount on British treasury bills is of interest:

> RULING. Where foreign corporations or nonresident alien individuals purchase British Government treasury bills at a discount in United States markets and *collect the same at maturity* either in the foreign country or from the paying agent of that Government in the United States, such discount is not income from sources within the United States and is not subject to tax.
>
> Where foreign corporations or nonresident alien individuals purchase British Government treasury bills at a discount in United States markets and *sell the same at a profit* in the United States, such profit is income from sources within the United States and as such is subject to tax. (C. B. 2, page 103; O. D. 534.)[26]

It has been held that income derived by a foreign partnership from goods purchased in the United States through a purchasing agent in this country and sold in foreign countries is not income from sources within the United States and hence is non-taxable.[27] Salary paid to a non-resident alien employee during a temporary visit to this country on business has been held not to be income from sources within the United States.[28] If an alien comes to this country with merchandise and sells it at a profit, he receives taxable income, irrespective of the time necessary to complete his sales.[29] Interest on tax-free covenant bonds of corporations organized in the United States doing no business and owning no property therein is

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[24] C. B. 1, page 101; O. D. 35.

[25] C. B. 1, page 183; O. D. 269.

[26] A similar ruling, making a distinction between profit on resale in the United States of foreign government or corporation bonds, which would be taxable, and profit realized at maturity of the bonds, which would not be taxable even though the bonds were paid off in the United States, was contained in a letter from Commissioner Wm. M. Williams to Morris F. Frey, dated March 21, 1921.

[27] C. B. 3, page 128; O. D. 592.

[28] C. B. 3, page 128; O. D. 578.

[29] C. B. 1, page 98; O. D. 291.

non-taxable when paid to non-resident aliens.[30] A non-resident alien corporation deriving profit from purchase or sale in this country of bank acceptances is taxable on such income, even though the corporation has no office or place of business in the United States.[31] Further information regarding "transacting business within the United States" and income from such sources is afforded by the following rulings:

RULINGS. In construing the provision of article 66 of Regulations 33, revised, that a foreign corporation is liable to tax with respect to income, the source of which is in the United States, and that the "source" as used therein means the place of origin, it is held that the place of origin thus referred to, is not restricted to the place where payment is made, since the place of payment may be arbitrarily selected without relation to the nature of the transaction and is not indicative of the source. Where the income grows out of a business activity in the United States it is immaterial where actual payment is made.

The provision of article 92 of Regulations 45, exempting from tax the charter money on freight shipments received by a foreign owner in regard to a vessel operated between the United States and a foreign port, is limited to foreign steamship companies having no office, connections or agency in the United States, whose vessels only occasionally touch at ports in the United States and who can not otherwise be regarded as doing business therein. (C. B. 3, page 265; O. D. 651.)

Amounts paid to a nonresident alien corporation not having an office or place of business in the United States as compensation for orders secured by it from foreign customers for export booked through such nonresident alien corporation are held not to be income from sources within the United States and not subject to withholding. (C. B. 1, page 232; O. D. 112.)

Profits derived by a foreign corporation having no office or place of business in the United States from a sale of goods to the United States Government are not subject to any income or profits taxes provided for by the Revenue Act of 1918, where the contract for sale was executed, the goods manufactured and delivered, and payment therefor received by the foreign corporation outside the United States. . . . . (C. B. 4, page 114; A. R. M. 113.)

Certain foreign corporations were organized for the purpose of manufacturing certain products. The entire capital stock of these companies is owned by a domestic corporation. The companies have

[30] C. B. 1, page 100; O. 908.
[31] C. B. 1, page 232; O. D. 221.

executive and administrative offices in the United States, maintained merely for the convenience of the domestic company which owns their stock, the offices which they maintain for business activities being located in the foreign country.

The companies' products are sold in the open market by the foreign organization. Any products sold to citizens of the United States or to domestic corporations are sold f. o. b. shipping point in the foreign country. The merchandise thus sold is invoiced by the United States office, but this is merely a part of the clerical detail. The sales are made by mail or through United States representatives visiting the plants in the foreign country, payments on the contracts being made through the office of the domestic corporation.

Held, that the sales are consummated and the title to the property passes in the foreign country. Any profit derived by the foreign corporations from such sales is not subject to tax under the provisions of the Revenue Act of 1918 as income from sources within the United States. (B. 46-20-1920; O. D. 1100.)

Regulation. While resident alien seamen are taxable like citizens on their entire income from whatever sources derived, nonresident alien seamen are taxable only on income from sources within the United States. Wages received for services rendered inside the territorial United States are to be regarded as from sources within the United States. The wages of an alien seaman earned on a coastwise vessel are from sources within the United States. . . . . There is no withholding from the wages of alien seamen unless they are nonresidents within the rules laid down in articles 311 to 315. Even in the case of a nonresident alien seaman, the employer is not obliged to withhold from wages unless those wages are from sources within the United States as defined above. . . . . (Art. 93.)

Ruling. The wages of nonresident alien seamen received for services rendered on vessels sailing from a United States port on the Pacific coast to a United States port on the Atlantic coast, or vice versa, via the Panama Canal, are subject to withholding. (C. B. 4, page 116; O. D. 784.)

Wages earned by non-resident aliens on vessels plying between continental United States and Porto Rico do not constitute income from sources within the United States. (C. B., 2, page 162; O. D. 536.) Wages earned by a non-resident alien on occasional coastwise voyages on a vessel regularly making foreign voyages have a taxable status.[32]

[32] C. B. 1, page 183; O. D. 245.

Ruling. An annuity paid by a domestic corporation to a non-resident alien individual is not subject to withholding except to the extent that the aggregate amount of the payments to the annuitant exceeds the amount paid to purchase the annuity. (B. 44-21-1898; O. D. 1086.)

Ruling. A foreign corporation derives income from sources within the United States in the form of dividends, received from stock owned by it in taxable subsidiary corporations organized and doing business in the United States. A portion of the stock of the foreign corporation is deposited with an American agent, who issues certificates of participation in such stock and the dividends thereon.

Held, that since the foreign corporation derives income from sources within the United States, any dividends received by individual holders of such certificates of participation may be claimed as a credit for the purpose of the normal tax as a deduction from gross income in the case of corporate holders of such certificates subject in the case of foreign corporation holders to the provisions of section 234 (b) of the statute. (I-2-22; I. T. 1160.)

The fact that foreign steamship companies having agents in the United States, receive income from sources within the United States to the extent of freight charges paid by domestic corporations, does not thereby make them receive income "from sources within the United States" under section 217 of the law.[33] Such instances are purely cases of domicile. To have taxable income, foreign corporations must be domiciled within the jurisdiction imposing the tax, or their property or business must be situated within such jurisdiction so that the income may be said to have a situs therein.[34]

Ruling. (1) There is no income from sources within the United States from goods manufactured there unless there is, in the language of section 233 (b),[35] both "manufacture and disposition of goods within the United States." The Act taxes only income that accrues within the United States.

(2) The mere buying of goods within the United States, with capital furnished from abroad, to be sold abroad, is not a trade or business exercised in the United States so as to subject the purchaser of

[33] Bulletin 36-21-1806; O. D. 1024.

[34] C. B. 3, page 21; T. D. 3111.

[35] [Former Procedure] According to section 233 (b) of the 1918 law, gross income included "all amounts received (although paid under a contract for sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States."

the goods to income tax. A merchant exercises his trade where he has his principal place of business, viz., where his profits come home to him.

If income be taxed the recipient thereof must have a domicile within the jurisdiction imposing the tax, or the property or business out of which the income issues must be situate within such jurisdiction so that the income may be said to have a situs therein.

(4) Where a corporation purchases goods abroad and sells them within the United States, the profits accruing from such transactions are profits derived from business carried on within the United States and the gross income from such business is income from sources within the United States.

(5) In the case of a partnership organized abroad, one of whose members is a resident citizen of the United States, and whose business consists in selling abroad goods consigned to it from various parts of the world, including the United States, upon commission, title to the goods never vesting in the firm, but passing directly from the consignors to the purchasers, the business of the United States member consisting of soliciting consignments of goods, disbursing proceeds of sales made abroad in payment to consignors in the United States, attending to the shipment of goods, and making advances to consignors on security of bills of lading and express receipts; the funds for the use of the branch office in the United States being obtained by selling drafts on a foreign city, only the income of the partner resident within the United States is income from sources within the United States and subject to income tax.

(6) A foreign corporation, having its home office abroad, which operates a line of steamships between the United States and foreign ports, consigns its steamships to an American firm, which handles them as agents and brokers, seeing to the entry and clearance of each steamer, the discharge and loading of cargo and supplies, collecting such part of the freight as is prepayable in this country, deducting the amount of its disbursements and charges and remitting the balance to the foreign corporation, derives income from sources within the United States to the extent that it derives income from traffic originating within the United States and is taxable upon such income. (C. B. 4, page 280; T. D. 3111.)

The place where property may be purchased does not affect the determination of the source from which any profit arising from its disposition within the United States is derived.[36] Income from property purchased within the United States but sold without is not taxable; income from property purchased

[36] C. B. 4, page 114; O. D. 89.

without the United States but sold within is taxable. The deciding factor is where the property may be *sold*.[37]

In connection with the foregoing rulings concerning steamship companies and foreign merchants, it is to be borne in mind that the 1921 law contains in section 217 (e) specific provisions providing for the allocation to United States sources of a portion of transportation or other services rendered partly within and partly without the United States and of a portion of the income derived from manufacture and sale when *either* of these operations occurred in the United States. Under the 1918 law profits from manufacturing operations were deemed to have been earned within the United States only when the goods were sold in this country.

Where foreign merchants merely purchase goods in the United States, as distinguished from producing them (in whole or in part) here, and sell them abroad, neither the 1921 nor the 1918 law deems any part of the profit to have arisen within the United States.

Allowable deductions.—The deductions of non-resident alien individuals are restricted by statute as follows:

LAW. Section 214. [Non-resident alien individuals] . . . . **(b) In the case of a nonresident alien individual, the deductions allowed in subdivision (a), except those allowed in paragraphs (5), (6), and (11), shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary. In the case of a citizen entitled to the benefits of section 262 the deductions shall be the same and shall be determined in the same manner as in the case of a nonresident alien individual.**

LAW. Section 234. [Foreign corporations] . . . . **(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment**

[37] The law, section 217 (e-2).

and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

REGULATIONS. Foreign corporations are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations,[38] to the extent that such deductions are connected with such gross income. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in Section 217. . . . . (Art. 573.)

The deductions provided for in section 214 shall be allowed to nonresident alien individuals and to citizens of the United States entitled to the benefits of section 262, and the deductions provided for in section 234 shall be allowed to foreign corporations and to domestic corporations entitled to the benefits of section 262, only if and to the extent that they are connected with income from sources within the United States. In the case of nonresident alien individuals, however, (1) losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business, are deductible only if and to the extent that the profit, if such transaction had resulted in a profit, would have been taxable as income from sources within the United States; (2) losses sustained during the taxable year of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise are deductible only if the property was located within the United States; and (3) contributions or gifts made within the taxable year are deductible only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 214 (a) (11) and article 251, or to the vocational rehabilitation fund.

Losses embraced under clauses (2) and (3) above are deductible in full from items of gross income specified as being derived in full from sources within the United States, but if greater than the sum of such items, the excess of unabsorbed loss may be deducted from the income apportioned to sources within the United States under the provisions of article 327. Losses embraced under clause (1) are deductible in full (as provided in article 325 or article 326) when the profit from the transaction, if it had resulted in a profit, would have been taxable in full as income from sources within the United States, but should be deducted under the provisions of article 327 when the profit from the transaction, if it had resulted in profit, would have

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[38] See Chapters XXV-XXXIV.

been taxable only in part. The amount of dividends included in the gross income may be deducted or credited, but in the case of a nonresident alien individual, for the purpose of the normal tax only. (Art. 324.)

Apportionment of deductions.—

Regulation. From the items specified in articles 317-323 as being derived specifically from sources within and without the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which can not definitely be allocated to some item or class of gross income. The remainder shall be included in full as income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Example.—A nonresident alien individual derived gross income from all sources for 1921 of $180,000. There was included therein:

$9,000	interest on bonds of a domestic corporation.
4,000	dividends on stock of a domestic corporation.
12,000	royalty for the use of patents within the United States.
11,000	gain from the sale of real property located within the United States.
$36,000	total.

That is, one-fifth of the total gross income was from sources within the United States. The remainder of the gross income was from sources without the United States, determined under article 322 above.

The expenses of the taxpayer for the year amounted to $78,000. Of these expenses the amount of $8,000, including such items as commission paid for the sale of the real property located within the United States and interest on indebtedness incurred to purchase the stock of a domestic corporation, is properly allocated to income from sources within the United States and the amount of $40,000 is properly allocated to income from sources without the United States.

The remainder of the expenses, $30,000, can not be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there is deducted from the $36,000 of gross income from sources within the United States, expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000, a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The

remainder, $22,000, is the net income from sources within the United States. (Art. 325.)

FILING OF RETURNS NECESSARY TO SECURE DEDUCTIONS AND CREDITS.—

REGULATION. Unless a nonresident alien individual, a foreign corporation, or a citizen of the United States or domestic corporation entitled to the benefits of section 262, shall file, or cause to be filed with the collector, a true and accurate return of income from sources within the United States, regardless of amount, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where a nonresident alien has various sources of income within the United States, so that from any one source or from all sources combined the amount of income shall call for the assessment of a surtax, and a return of income shall not be filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the income of such nonresident alien from all sources concerning which he has information, and he will assess the tax and collect it from one or more of the sources of income within the United States of such nonresident alien, without allowance for deductions or credits. . . . . (Art. 329.)

Credits allowed to individuals.[39]—Non-resident alien individuals are allowed a specific exemption of $1,000 whatever their status and without regard to the reciprocal provisions extended by the country of which they are nationals. No additional allowances are permitted for dependents.

LAW. Section 216. . . . . **(e) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the per-**

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[39] [Former Procedure] Under the 1918 law credits allowed nonresident alien individuals were the same as in the case of citizens or residents, conditional upon the country of which they were citizens allowing similar credits to citizens of the United States. See 1918 law, section 216 (e), and *Income Tax Procedure,* 1921, pages 992 and 993. To the countries named in *Income Tax Procedure,* 1921, must be added the following:

Under class (a): Malta, Albania, Basutoland, Ceylon, Gambia, Grenada, Mauritius, N. Rhodesia, Sierra Leone, Virgin Islands (British), Zanzibar, Bechuanaland, Cyprus, Gibraltar, Hongkong, Montserrat, Nyasaland Protectorate, Somaliland, Weihaiwei, British Guiana, Falkland Islands, Gold Coast, Malay States, Nigeria, St. Helena, Swaziland, Uganda, Palestine, Armenia, Syria, Jamaica, Barbados, Germany, Hungary, Fiji Islands, Western Pacific Islands, Kenya and St. Kitts-Nevis, British Honduras.

Under class (b): Poland (formerly Prussian Poland). Not satisfying section 216 (e). Trinidad, Dutch Guiana, Straits Settlements.

sonal exemption shall be only $1,000, and he shall not be entitled to the credit provided in subdivision (d) . . . .

REGULATIONS. A citizen entitled to benefits of section 262 and a nonresident alien individual, similarly to a citizen or resident, are entitled for the purpose of the normal tax to the dividend credit described in article 301. They are also entitled in every case to a personal exemption of $1,000, but under no circumstances to any credit for dependents. Under the Revenue Act of 1921, the provisions of tax laws of the foreign country of which a nonresident is a citizen or subject are immaterial, the right to a personal exemption of $1,000 being absolute. (Art. 306.)

. . . . The benefit of the credits allowed against net income for the purpose of the normal tax may not be received by a nonresident alien by filing a claim with the withholding agent, but only by claiming it upon filing a return of income, except as permitted in articles 315 and 364. . . . . (Art. 329.)

The specific exemption is dependent upon the status of the taxpayer on the last day of the period covered by his return.

Credits allowed a foreign corporation.—A foreign corporation is allowed the same credits as a domestic corporation, excepting the specific exemption of $2,000 to corporations with income not exceeding $25,000, which is not allowed.[40] A foreign corporation, like a non-resident alien individual, can obtain the full benefit of credits only by filing a complete return of income from sources within the United States.

Income of foreign corporations received on and after March 3, 1919, from bonds, notes and certificates of indebtedness of the United States and bonds of the War Finance Corporation, is exempt from income and profits taxes. Such income is not included in gross income, and, of course, a credit cannot be taken therefor except for such income received prior to March 3, 1919.

As is the case of non-resident alien individuals, a foreign corporation is permitted a credit against its taxes[41] for any amounts withheld at the source. The gross income, in-

[40] See Art. 591.
[41] This should not be confused with credits against income.

cluding income upon which any tax is withheld at source, must be included in the return.

Rates of tax for non-resident alien individuals.[42]**—**

LAW. Section 210. . . . . **there shall be levied, collected, and for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: . . . .**

Rates of surtax.—Rates of surtax on the income of non-resident aliens are the same as in the case of citizens or residents of the United States as given in section 211. (See Chapter VII, page 156.)

Rates of tax for foreign corporations.—

LAW. Section 230. . . . . **(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236;**[43] **and**

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

Returns of non-resident alien individuals.—

REGULATION A nonresident alien individual shall make or have made a full and accurate return on form 1040B of his income received from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source. . . . . The responsible representatives of nonresident aliens in connection with any sources of income which such nonresident aliens may have within the United States shall make a return of such income, and shall pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their nonresident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. . . . . (Art. 404.)

Returns required of aliens to secure sailing permits.—Section 250 (g) of the 1918 law has been amplified to include specific reference to the cases of departing aliens and imposing a penalty for any attempt to violate this section of the law.

[42] Normal tax on the first $4,000 of net income at the rate of 4 per cent applies only to citizens and residents.

[43] See Chapter XII for credits enumerated under section 236.

LAW. Section 250. . . . . (g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable.[44] In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed; or paying such respective taxes. In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdi-

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[44] The same personal exemption is allowed as if return were for a full taxable period. (Reg. 45, Art. 1013.) Credit should be taken for any taxes withheld at source. (C. B. 1, page 253; Mim. 2195.)

vision there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due.

(h) The provisions of subdivisions (e), (f) and (g) of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act.

The fact that a non-resident alien has executed a power of attorney authorizing a domestic bank to act as its agent in all income tax matters, does not relieve a domestic corporation paying royalties to such non-resident alien from the withholding requirements of the law.

The various instructions issued with respect to departing aliens are not applicable to representatives of foreign countries bearing diplomatic passports.[45]

Responsibility of agent for making return.—

REGULATION. . . . . The agent of a nonresident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. Where upon filing a return of income it appears that a nonresident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. . . . (Art. 404.)

Domestic corporations handling specific transactions for foreign customers but not as agents are not required to file returns or withhold taxes for such customers.

In the case of a commission house in the United States which bought and sold cotton for English mills, the Commissioner ruled as follows on the question of whether either the making of a return or the withholding of tax was required of the commission house.

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[45] Bulletin 44-21-1899; O. D. 1087.

Ruling. . . . . Inasmuch as you state that you have not been designated to act as agent for the foreign corporations in question, to prepare their tax returns, or to otherwise assume general agency obligations, and since you were instructed merely to handle specific transactions for such corporations, the same way that any customer might instruct a stock broker to buy or sell securities for his account, it is held that you were not agent for the foreign corporations in transactions of the character stated, within the meaning of the statute and regulations before mentioned, and, therefore, are not required to file a return for the foreign corporations for whom such purchases and sales were made. . . . . You are not required to withhold the tax from the income accrued to foreign corporations in transactions such as those described, as the income arising therefrom is not deemed to be fixed or determinable annual or periodical income within the meaning of Section 221 of the Revenue Act of 1918 requiring withholding. (Letter of Commissioner D. H. Blair, dated June 8, 1921.)

Return for non-resident alien beneficiary.[46]—

Regulation. Where a citizen or resident fiduciary has the distribution of the income of a trust any beneficiary of which is a nonresident alien, the fiduciary shall make a return on Form 1040 B for such nonresident alien and pay any tax shown thereon to be due. Unless such return is a true and accurate return of the nonresident alien beneficiary's income from all sources within the United States the benefits of the credits and deductions to which the beneficiary is entitled can not be obtained in the return filed by the fiduciary. . . . . If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns the fiduciary shall be relieved from the necessity of filing Form 1040 B in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. If there are two or more nonresident alien beneficiaries the fiduciary shall render a return on Form 1041[47] and also a return on Form 1040 B for each nonresident alien beneficiary. . . . . (Art. 425.)

Ruling. Where two separate trusts are created for the same nonresident alien beneficiary, each trustee is required to render a personal return on Form 1040 or 1040-A on behalf of the nonresident alien, and pay any and all normal tax found by such return to be due and any and all surtax, provided the income is not returned for the purpose of the tax by the beneficiary.

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[46] See Chapter XXXVII for general discussion of fiduciaries.

[47] See Appendix B.

If one of the trustees is the representative or authorized agent of the nonresident alien, he may render a complete return on Form 1040 or 1040-A, combining the entire net income from both trusts and take credit on the return for any tax paid by the other fiduciary in behalf of the nonresident alien.

If the nonresident alien beneficiary of the two trusts should appoint a resident agent for the purpose of filing his return and paying the tax in his behalf, it would not be necessary for the two trustees to file returns on Form 1040 or 1040-A, provided they have received notice of such appointment. The fiduciaries, however, would not be relieved from liability for rendering returns as such on Form 1041, as required by law. (C. B. 3, page 229; O. D. 572.)

Returns on form 1040 are required even though the alien's income consists entirely of dividends and is less than $5,000.[48]

Record owner of stock is responsible for making return and paying surtax due.[49]—

Regulation. Dividends on stock of domestic corporations or resident foreign corporations are prima facie income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure of the actual ownership is made to the Commissioner on Form 1087 which shall show that the record owner is not the actual owner and who the owner is and his address. In all cases where the actual owner is a nonresident alien individual and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control and disposal of the dividend income and will be required to make return for the actual owner, regardless of the amount of the income, and to pay any surtax found by such return to be due. (Art. 405.)

Forms for making individual returns.—

Regulation. Nonresident alien individuals or their authorized agents should use form 1040 (revised) or 1040A (revised) in making returns of income derived from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source. If a nonresident alien individual is not liable for any tax which has been withheld at the source, no refund of such tax will be permitted unless such a return is filed and a statement is attached thereto indicating the amounts of the tax withheld and the names and post office addresses of all with-

[48] Bulletin 1-19-79; O. D. 58.

[49] See also Chapter X, page 318, for use of form 1087.

holding agents. Unless a nonresident alien individual shall render a return of income, the tax will be collected on the basis of his gross income (not his net income) from sources within the United States. (Extract from T. D. 2815; dated April 2, 1919.)

Form 1040C has been issued for the use of non-resident alien individuals having net incomes of not more than $5,000 for the taxable period 1921. This form is largely used with sailing permits for aliens. In accounting for net incomes of over $5,000, form 1040 must be used, as stated above.

Returns for foreign partnerships.—While foreign partnerships as well as domestic partnerships are not taxed as business entities, returns on form 1065, regardless of the amount of income, are required to show the distributive shares of the partners, whether or not distributed.[50] Foreign partnerships account only for taxable income from sources within the United States on form 1065, and are required to file returns if they transact business within the United States.

LAW. Section 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

REGULATION. Every partnership must make a return of income, regardless of the amount of its net income. The return shall be on Form 1065 and shall be sworn to by one of the partners. Such return shall be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year as the case may be), irrespective of the taxable years of the partners. . . . . (Art. 411.)

Returns for foreign corporations.—

REGULATION. Every foreign corporation and corporation satisfying the conditions set forth under section 262, having income from sources within the United States must make a return of income on Form 1120. If such a corporation has no office or place of business

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[50] See page 1308 for discussion of partnership income.

here, but has a resident agent, he shall make the return. It is not necessary, however, for it to be required to make a return that the foreign corporation shall be engaged in business in this country or that it have any office, branch, or agency in the United States. . . . (Art. 625.)

Consolidated returns.[51]—Power is given to the Commissioner to consolidate the returns of foreign corporations whenever he deems it proper to do so. Given this discretion, he should be asked to exercise it where circumstances justify the request and where it would prevent what would otherwise be an evident hardship on the corporations involved.

LAW. Section 240. . . . . (d) **For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation:** *Provided*, **That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses. . . .**

Return by agent.[52]—Section 239 provides that "if any foreign corporation has no office or place of business in the United States, but has an agent in the United States, the return shall be made by the agent." (See article 625, page 1302.)

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[51] **[Former Procedure]** Under the 1918 law no provision was made for the consolidation of returns for foreign corporations. It was provided, however, that in case a domestic corporation controlled a foreign corporation, a credit should be given for taxes paid by the foreign corporation. This provision [section 240 (c)] has been materially modified [it is section 238 (c) of the 1921] law. See Chapter XXVIII.

[52] RULING. "An insurance broker in the United States who solicits and procures insurance for nonresident foreign corporations, collects the premiums thereon and credits the accounts of the respective corporations with the net proceeds after deductions are made, is considered the resident agent of such foreign corporations with respect to the business obtained through his efforts and is required to file returns for each nonresident foreign corporation covering the gross income received from sources within the United States within the purview of his agency, claiming therein any deductions to which the corporations are entitled and to pay the total tax due thereon." (C. B. 3, page 284; O. D. 586.)

Time and place for filing non-resident individual returns.[53]—

LAW. Section 227. (a) . . . . In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

Time and place for filing corporation returns.—

LAW. Section 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

Returns in respect of money and other property surrendered to the Alien Property Custodian.—

RULING. Receipt is acknowledged of your letter dated October 30, 1919, stating that the . . . . Trust Company is attorney-in-fact for a non-resident alien client who is held to be an enemy by the Alien Property Custodian. On August 22, 1918, the Trust Company surrendered to the Alien Property Custodian all money and securities in its possession belonging to its client. Your statement is noted, referring to article 446 of Regulations 45, that apparently the Trust Company was required to render a return at the time the money and securities were relinquished, ...

In reply, you are advised that at the time the . . . . Trust

[53] Form 1065 for foreign partnerships is filed under the same conditions as for individuals.

Company turned over the money and securities of its enemy client to the Alien Property Custodian, the provisions of T. D. 2673, dated March 18, 1918, were in force. Under that decision it was required that "All persons who on October 6, 1917, had, or since have had, or may hereafter have, control of any money or other property for any enemy or ally of enemy, or who on October 6, 1917, were, or since have been, or may hereafter be, indebted to any enemy or ally of enemy, shall hold and deliver all said money and property in all respects subject to the provisions of the Trading with the Enemy Act and to the order of the President of the United States and of the Alien Property Custodian thereunder, and shall in *due course* file returns of income in respect of all said money and property for such periods as may elapse or have elapsed prior to the actual delivery of said money and property to the Alien Property Custodian."

This decision was substantially repeated in article 446. Neither the language of the original ruling nor that of article 446 can be so construed as to require the filing of returns at the time of surrendering the money and property of enemies to the Alien Property Custodian. But as indicated in the last sentence of the decision given above, returns of income are to be filed in *due course,* which is held to mean by the next regular due date for the filing of returns of income. The following ruling of the Alien Property Custodian under T. D. 2673 is approved and quoted for your information, to wit: "Return of income is required to be filed in due course in respect of all money or other property for such part of the year 1918, or any subsequent year as may elapse prior to the actual delivery of the money or other property to the Alien Property Custodian, but no withholding or the payment of any taxes is required." (Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated January 19, 1920.)

When tax shown to be due by return is payable.—Payment of tax shown to be due by returns as previously described shall be made when returns are filed or in instalments in accordance with the provisions of section 250. (See Chapter VIII, page 217.)

Extension of time for filing returns.—The 1921 law gives non-resident alien individuals and foreign corporations having no place of business in the United States three months longer for filing returns than is allowed residents of the United States.[1] Consequently it should be possible for most foreign

[1] See section 227 on page 1304.

taxpayers to file their returns within the required time without securing an extension. The Commissioner is authorized, however, to grant a reasonable extension of time when good cause therefore exists.

Withholding from Non-Resident Aliens

The tax is collected from non-resident aliens in two ways: (1) Payment by the aliens of the tax shown to be due by returns filed; (2) withholding of normal tax at the source in the case of all payments of fixed and determinable annual or other periodical income. In the case of income from which tax is deducted at the source, non-resident aliens are required to include the gross payments in their returns, but a credit is allowed *against tax* for the amount which has been deducted at the source. There is withholding at the source *only* in the case of income described as "fixed and determinable, annual or periodical," and the withholding provisions of the law do not apply to foreign partnerships, except in the case of payment of interest on tax-free covenant bonds. Chapter X discusses in detail the use of various forms of ownership certificates and the use of withholding returns in lieu of information returns. Chapter XI explains the legal theory underlying tax-free covenants in bonds and withholding from citizens or residents.

Withholding of tax at the source.—

LAW. Section 221. **(a) That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States, and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends**

of the class allowed as a credit by subdivision (a) of section 216) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1, a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g) of section 217.[55] . . . .

LAW. Section 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided,* That in the case of interest described in sub-

[55] Withholding in the case of payments described in section 221 (a) (rent, salaries, etc.) is at the rate of 8 per cent, that being the normal tax rate prescribed by law for 1919 and subsequent years. Withholding of tax on interest on so-called tax-free bonds, however, is only at the rate of 2 per cent.

division (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

Regulation. With respect to payments to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, withholding is required of a tax of 2 per cent in the case of interest payable upon corporate bonds or other obligations containing a tax-free covenant clause, and of a tax of 12½ per cent (10 per cent during the calendar year 1921) in the case of other fixed or determinable annual or periodical income, other than corporate dividends. . . . . To enable debtors in the United States to distinguish between foreign corporations which have and those which have not any office or place of business in the United States, and also to enable such corporations as have an office or place of business in the United States to claim exemption from withholding the tax on bond interest or other income, a certificate, Form 1086, stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor. (Art. 601.)

Ruling. The obligation of a person in the United States to pay to a foreign bank amounts representing drafts and interest thereon, drawn by him and accepted by the foreign bank, is such an "interest-bearing obligation" as is contemplated by section 233 (b), regardless of the fact that the debt was incurred outside the United States and the interest was paid in a foreign country in foreign money. The interest is subject to withholding. . . . . (B. 41-21-1863; O. D. 1062.)

Withholding in case of partnerships.—A partnership composed in whole or in part of non-resident aliens, is subject to the withholding provisions of the statute.

Ruling. . . . . Withholding required from payments of income specified in Section 221 (a) Revenue Act of 1921 made to partnerships composed in whole or in part of nonresident aliens. (Telegram signed by Commissioner D. H. Blair, and dated December 8, 1921.)

Nevertheless, the foregoing does not apply in the case of a partnership having an office or place of business in the United States.

Ruling. Section 221 of the Revenue Act of 1921 provides for withholding of a tax equal to 8 per cent from the annual or periodical gains, profits, or income of a partnership composed in whole or in part of nonresident aliens. (See sec. 221.) However, in the

case of a partnership having an office or place of business in the United States, withholding will not be required, even though one or more of the members thereof is a nonresident alien; the partnership, however, as agent of the nonresident alien member or members, shall file a return of the income of such nonresident alien member or members in accordance with the provision of article 404 of Regulations 45, and the corresponding article of Regulations 62, to be promulgated under the Revenue Act of 1921.

Approved January 5, 1922. (I-3-34; T. D. 3268.)

Filing of return by foreign corporation does not relieve withholding.[56]—

RULING. A domestic corporation making payments of fixed or determinable annual or periodical income to a nonresident foreign corporation is not relieved from compliance with the withholding requirements of the income tax law on account of the fact that the nonresident foreign corporation has filed Federal income tax returns and claims for refund of excess taxes paid during prior years. (C. B. 4, page 302; O. D. 853.)

Definition of withholding agent. —

REGULATION. . . . . A withholding agent may be a corporation with bonds outstanding, a trustee under a corporate mortgage, or any corporation, partnership or private individual. . . . . (Art. 1533.)

ASSIGNEE MUST WITHHOLD.—

REGULATION. . . . . Where in connection with the sale of its property payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, corporation, or a State or political subdivision thereof, must deduct and withhold such taxes as would have been required to be withheld by the assignor had no such sale and transfer been made. . . . . (Art. 365. Reg. 45, Art. 364.)

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[56] [Former Procedure]

RULING. "A tax of 10 per cent is required to be withheld from the interest credited by a domestic bank to the account of a foreign corporation not having any office or place of business in the United States regardless of the fact that the foreign corporation intends to file an income tax return covering its income from all sources within the United States." (C. B. 4, page 302; O. D. 910.)

As interest on deposits with domestic banks is no longer taxable to foreign corporations not doing business in the United States, the foregoing ruling is to that extent obsolete.

What is fixed and determinable annual or periodical income?—

REGULATION. Only (*a*) fixed or determinable (*b*) annual or periodical income is subject to withholding. Among such income, giving an idea of the general character of income intended, the statute specifies interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. But other kinds of income may be included. (*a*) Income is fixed when it is to be paid in amounts definitely predetermined. On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. (*b*) The income need not be paid annually if it is paid periodically, that is to say, from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. (Art. 362.)

RULINGS. The excess of the face value of a so-called bank acceptance as collected at its maturity, over the amount paid therefor by a person collecting the acceptance at maturity, is not interest within the meaning of sections 221 (a) and 237 of the Revenue Act of 1918.

Gains and profits derived from the purchase and sale of so-called bank acceptances are not fixed and determinable annual or periodical income within the meaning of sections 221 (a) and 237, and are not subject to the withholding provisions of the act. (C. B. 2, page 189; O. 1024.)

The tax should be withheld on payments by an American corporation to a nonresident foreign corporation having no office or place of business within the United States, representing royalties for the use of a patent, regardless of whether the amount paid is an agreed sum or is contingent on profits earned. The entire royalty, if not unreasonable, may be taken as a deduction by the American corporation. (C. B. 1, page 230; T. B. R. 29.)

Winnings of horses at a race track credited by the racing association to a nonresident alien owner and trainer of the horses winning such amounts are not fixed nor determinable annual or periodical gains, profits, and income within the meaning of section 221 (a), Revenue Act of 1918, and no withholding by the racing association is necessary. (B. 2-19-157; S. 975.)

A firm of ship chandlers bills its sales to ships' captains at the list price of the goods but accepts a lesser sum in full settlement in order to secure their trade. No payments whatever were made by

the firm to the ships' captains, who in this case were nonresident aliens. It is presumed that the captain of the ship in each case collected the face of the bill from the owner of the ship or his employer. The mere fact that the firm billed the goods to the ships' captains at list price, entered such amounts on its books, but accepted in payment amounts less than list price, can not in the judgment of the Committee make the firm the payer of discount or commission to the ships' captains. Since the firm made no payments of fixed or determinable annual or periodical income to the nonresident alien ships' captains, there would be no amounts from which withholding is required. (C. B. 1, page 184; A. R. R. 265.)

While certain income payments do not require withholding, such payments, nevertheless, have a taxable status. In other words, relief from withholding does not make income non-taxable.[57]

No withholding from interest on bank balances in certain cases.—Under the 1921 law interest paid to non-resident aliens not having a place of business in the United States, on deposits in domestic banks, is specifically exempt from taxation.[58]

REGULATION. Under the Revenue Act of 1921 persons carrying on the banking business within the United States are not required to withhold any tax from interest on bank deposits which is paid to (or credited to the accounts of) persons not engaged in business within the United States and not having an office or place of business therein. Any tax which, subsequent to December 31, 1920, and pursuant to the Revenue Act of 1918, had been withheld by persons carrying on the banking business within the United States from interest on bank deposits paid to (or credited to the accounts of) non-resident alien individuals not engaged in business within the United States and not having an office or place of business therein, or foreign corporations not engaged in business within the United States and not having an office or place of business therein, shall be released and paid over to such nonresident alien individual or foreign corporation, or his or its representative. (Art. 372.)

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[57] Section 217 (a).

[58] [Former Procedure] Under the 1918 law interest on bank balances paid or credited to non-resident alien individuals or foreign corporations was subject to withholding. See *Income Tax Procedure*, 1921, pages 1010 and 1011.

Withholding from bond interest and ownership certificates required.—

1. Form 1000 (revised).—This form must be used in collecting interest on bonds in all cases in which there is withholding at the source. A tax of 2 per cent must be withheld on bonds of domestic or resident corporations containing a tax-free covenant clause if the owner is (a) a non-resident alien individual or fiduciary, (b) a foreign partnership, (c) a foreign corporation not having an office or place of business within the United States.

If such bonds do not contain a tax-free covenant clause, a tax of 8 per cent must be withheld in the case of non-resident alien individuals or fiduciaries, and 10 per cent[59] in the case of corporations not having an office or place of business within the United States.

A foreign corporation not engaged in trade or business within the United States but having a fiscal agent in this country is not a resident corporation[60] and should use form 1000 in collecting interest on tax-free covenant bonds of domestic or resident corporations. It is held,[61] however, that a resident fiscal agent or a resident paying agent of a foreign corporation or country which has issued bonds containing a tax-free covenant clause is required to withhold a tax of 2 per cent from interest on such bonds, when form 1000 (revised) is used by (a) citizens or residents not claiming exemption, (b) domestic or resident partnerships or (c) approved personal service corporations.[62] It will be noted that such a foreign debtor is not required to withhold against domestic or resident corporations owning its bonds. Citizens or residents may claim personal exemption on such interest payments by filing form 1001A (revised).

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[59] Increased to 12½ per cent from January 1, 1922, by section 237 of the 1921 law.

[60] Bulletin 4-19-225; O. D. 144.

[61] Letter to The Equitable Trust Company of New York, N. Y., signed by Paul F. Myers, Acting Commissioner and dated July 7, 1920.

[62] No corporations are classed as personal service corporations after December 31, 1921.

2. Form 1001 (revised).—This form should be used by foreign partnerships in collecting interest on bonds of domestic or resident corporations which do not contain a tax-free covenant clause and by foreign corporations having an office or place of business within the United States, foreign governments and exempt foreign corporations, regardless of whether the bonds contain a tax-free covenant clause or not. There is no withholding if this form is used.

3. Form 1001A (revised).—This form is used for interest payments on foreign bonds when no withholding is required and for foreign dividend payments. Such income is not taxable in the case of non-resident aliens, although the funds pass through domestic banking channels for payment.[63] The form may be executed on behalf of a non-resident alien individual, fiduciary, partnership or corporation by any responsible foreign or domestic banker having knowledge of the ownership of such securities. The name of the foreign owner need not be supplied, but the due date and date paid must be given. The paying agent, if within the United States, is treated as the source of information; otherwise the *last bank or collecting agent is so regarded.*

4. Form 1001B.—This form is used by non-resident aliens when a personal exemption is claimed in collecting interest on tax-free covenant bonds.[64]

The use of substitute certificates is not permitted in case of foreign payments.[65]

Exemption claim of alien in collecting tax-free covenant bond interest—form 1001B.[66]—

Exemption certificates of non-resident aliens.—

Regulation. (a) When the gross income (including bond interest) of a nonresident alien, which is derived from sources within

[63] See page 309.
[64] See page 309.
[65] Art. 368; see page 311.
[66] See page 331 for discussion of when citizens or residents should claim exemption on tax-free covenant bonds.

the United States, does not exceed the personal exemption of $1,000, allowed by section 216 (e), an exemption certificate, Form 1001 B, should be executed and filed with the withholding agent, if any part of the gross income is derived from interest upon bonds or similar obligations of a domestic corporation which contain a tax-free covenant clause. The amount of tax due from the withholding agent, as shown by Form 1013, may be reduced by 2 per cent of the aggregate amount of interest payments made to such nonresident alien upon tax-free covenant bonds during the calendar year.

(b) When the gross income of a nonresident alien, derived from sources within the United States, does not exceed $1,000, such person may file with the withholding agent an exemption certificate on Form 1001 C with respect to interest upon bonds or similar obligations of a domestic corporation not containing a tax-free covenant clause. The debtor organization or withholding agent, upon receipt of a properly excuted certificate showing that the individual's income does not exceed $1,000, shall release and pay over to such individual upon demand any tax withheld during the preceding calendar year. The tax assessed against the withholding agent and which has not been paid may be made the subject of a claim for abatement to the extent of the amount of excess tax withheld, and refunded to the alien on the basis of this certificate. In case the tax so withheld has been paid to the Government, refund of the tax withheld in the case of non tax-free bonds and similar obligations can only be made to the bond owner or his duly authorized representative.

The exemption certificates, Forms 1001 B and 1001 C, properly executed, may be filed with the debtor organization or its duly authorized withholding agent at any time after the close of the calendar year, but not later than May 1 of the succeeding year. Ownership certificates, however, must be filed in connection with all interest payments upon bonds and similar obligations of domestic corporations in accordance with the regulations, notwithstanding the fact that Form 1001 B or Form 1001 C is filed. (Art. 364.)

Ruling. . . . . While form 1001B was intended, primarily, for reporting 1919 income, it may be adopted for reporting any interest received in respect of the years 1916 and 1918, in which case a separate form should be filed for each of those years, in respect of which the nonresident alien has received interest during the calendar year. (Extract from letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated February 3, 1920.)

Procedure when foreign item is presented without ownership certificate and owner is unknown.—

Ruling. In case foreign item is unaccompanied by certificate and owner is unknown, affidavit and form 1001A, revised, showing name

and address of payee should be executed by first bank unless item represents interest on bonds containing tax free covenant issued by foreign country or corporation having paying agent in U. S. in which case affidavit and form 1000, revised, should be executed by first bank in accordance with article 368.[67] For audit purposes payee will be considered actual owner. (Telegram to the Equitable Trust Company, New York, signed by Commissioner Daniel C. Roper, and dated January 20, 1920.)

No withholding on bond interest due prior to March 1, 1913.—

RULING. Coupons which became due June 1, 1910, presented on behalf of non-resident alien individual owner. Should the federal income tax be withheld therefrom? Please wire reply. (Answer.) Bond interest represents income to taxpayer when due and payable in accordance with article 54, Regulations 45. No tax required to be withheld from interest upon bonds due prior to March 1, 1913, but paid subsequent to that date. (Telegram from Chicago & Northwestern Railway Company and the answer thereto, signed by Acting Commissioner Callan and dated August 26, 1919.)

Withholding is required at the rates for the year in which coupons are paid, but if they became due and payable in prior years, a claim for refund of excess tax withheld may be made.—

RULING. Income tax should be withheld from interest payments to nonresident aliens upon bonds at rates in force during year in which payments were actually made, although bond interest is held to represent income for year during which coupons became due and payable. Any tax withheld and paid to Government in excess of taxpayer's liability may be adjusted through claim for refund. (C. B. 1, page 182; O. D. 167.)

Duties and obligations of employers, in connection with withholding, in the case of non-resident aliens employed in the United States.—Employers are held liable for deduction of income tax from salaries, wages, or other fixed and determinable annual or other periodical income paid to non-resident alien employees since September 17, 1915, the date of issuance

[67] See page 310.

of T. D. 2242, which defined a non-resident alien and prescribed the certificate of residence, form 1078.[68] If it can be established, as provided in articles 312 to 316 that the alien employee had in fact acquired residence, the employer will not be liable for tax, because no withholding is required in case of resident aliens.[69]

ALLOWANCE OF PERSONAL EXEMPTION[70] TO NON-RESIDENT ALIEN EMPLOYEE.—

REGULATION. A nonresident alien employee may claim the benefit of the credit for personal exemption by filing with his employer Form 1115, duly filled out and executed under oath. On the filing of such a claim the employer shall examine it. If on such examination it appears that the claim is in due form, that it contains no statement which to the knowledge of the employer is untrue, that such employee on the face of the claim is entitled to credit, and that such credit has not yet been exhausted, such employer need not until such credit be in fact exhausted withhold any tax from payments of salary or wages made to such employee. Every employer with whom affidavits of claim on Form 1115 are filed by employees shall preserve such affidavits until the following calendar year, and shall then file them, attached to his annual withholding return on Form 1042, with the collector on or before March 1. In case, however, when the following calendar year arrives such employer has no withholding to return, he shall forward all such affidavits of claim directly to the Commissioner, with a letter of transmittal, on or before March 15. Where any tax is withheld the employer in every instance shall show on the pay envelope or shall furnish some other memorandum showing the name of the employee, the date and the amount withheld. This article applies only to payments of compensation by an employer to an employee. . . . . (Art. 315; Reg. 45, Art. 316.)

Form 1115, used to secure relief from withholding by a non-resident alien employee, may also be used by aliens other than employees to establish credit for personal exemption when a complete return of income from sources within the United States is filed.[71]

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[68] See *Income Tax Procedure*, 1920, page 857.
[69] See pages 1273-1276.
[70] See page 1295.
[71] See page 1296.

Refund of taxes erroneously withheld if alien cannot be found.—

Ruling. Tax erroneously withheld from the wages of a nonresident alien seaman, who can not now be located for the purpose of making refund, should be reported on the annual list return, Form 1042, and paid to the Government, and when the seaman is located he should be advised of his right to file claim for refund. (B. 16-19-463; O. D. 258.)

Refund of tax on establishment of residence.—

Rulings. In cases where tax was withheld from wages of employees who refused to sign the old Form 1078, but who have now signed the new Form 1078, the amount of tax should not be refunded by the employer upon execution of the new Form 1078. The amount of tax withheld should be reported on Form 1042 and paid to the collector of internal revenue for the district in which the withholding agent is located, subject to claim for personal exemption provided in section 216 of the Revenue Act of 1918.

If the personal exemption is not available to the nonresident alien, the amount of tax can be refunded only upon execution of Form 46, accompanied by a complete return of the individual's income from sources within the United States, and evidence establishing the fact that tax has been withheld in excess of the actual liability. (C. B. 1, page 184; O. D. 107.)

Any income tax withheld during the calendar year from the wages paid to an alien employee, which has not been paid over to the Government, should be refunded to such alien employee upon the establishment of residence by the execution and filing of Form 1078 with his employer. As a condition precedent the employer should require the employee to return the receipts showing the amount of tax previously withheld before making the refund. (C. B. 1, page 165; O. D. 302.)

The fact that an alien has been employed by a resident corporation for at least three months is not ipso facto sufficient to permit the employer to refund the amount of any tax withheld. Forms 1115 and 1078 should be filed by resident or nonresident aliens in order to secure refund. (C. B. 1, page 165; O. D. 254.)

Alien employees—resident and non-resident—withholding upon change of status.—

Rulings. . . . . Where the status of an alien changes during the year from that of a resident to that of a non-resident, or from that of a non-resident to that of a resident, the status which exists at the

end of the taxable year is the one which determines his right to exemption as to the whole year. Where an employer has withheld wages from a non-resident during part of the year and thereafter the employee became a resident (before the employer has paid over to the United States the amount withheld), the employer is authorized on receiving proof of the change to refund to the employee the amounts which had been withheld from him during the earlier part of the taxable year, while his status was that of a non-resident. . . . . (Extract from letter to W. B. Reed, Accounting Secretary, National Coal Association, Washington, D. C., signed by Commissioner Daniel C. Roper, and dated June 12, 1919.)

. . . . If the status of a resident employee changes to that of a non-resident alien, the employer should withhold income tax at the rate of eight per cent from all wages paid to the non-resident employee on and after the date on which the employer had knowledge of the change. Although the employee, in such case, will be taxable as a non-resident alien for the entire taxable year during which his status is changed from that of a resident to that of a non-resident alien, the employer will not be held liable for the deduction of income tax with respect to wages paid preceding the knowledge of the employer as to the change in status. (Extract from letter to W. B. Reed, Accounting Secretary, National Coal Association, Washington, D. C., signed by Commissioner Daniel C. Roper, and dated August 6, 1919.)

Return of tax withheld.[72]**—**

REGULATION. (*a*) Every withholding agent shall make an annual return to the collector of the tax withheld from interest on corporate

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[72] **[Former Procedure] Withholding from non-resident aliens at 1917 rates prior to February 25, 1919.—**

REGULATION. "In the case of payments made prior to February 25, 1919, where a withholding agent pursuant to the Revenue Acts of 1916 and 1917 withheld only 2 per cent from the income of nonresident alien individuals, he need return only such sum. In all such cases where a withholding agent withheld the tax pursuant to the Revenue Acts of 1916 and 1917 from the income of foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, he need return only the sum withheld, to an amount not in excess of the aggregate sum required to be withheld by the terms of the Revenue Act of 1918 from the income paid over by the withholding agent. In the case of every payment made after February 24, 1919, the withholding agent must withhold at the rates prescribed by the present statute from the whole payment, not merely from that part which applies to the period after February 24, 1919." (Reg. 45, Art. 371.)

Withholding in 1918.—

REGULATION. "Any sum withheld for tax since December 31, 1917, in excess of the aggregate amount required under the terms of the

bonds or other obligations on or before March 1 on Form 1013. He shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The original ownership certificates, or the substitute certificates where authorized, must be forwarded to the Commissioner with the monthly return. (*b*) Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the collector on or before March 1 on Form 1042 showing the amount of tax required to be withheld for each nonresident alien individual, partnership composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, to whom income other than bond interest was paid during the previous taxable year. In every case of both classes the tax withheld must be paid on or before June 15 of each year to the collector. . . . . (Art. 371; Reg. 45, Art. 370.)

Return of income from which tax withheld.—

Regulation. The entire amount of the income from which the tax was withheld shall be included in gross income without deduction for such payment of the tax. But any tax actually so withheld shall be credited against the total tax as computed in the taxpayer's return. . . . . If the tax is paid by the recipient of the income or by the withholding agent it shall not be re-collected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved. (Art. 375; Reg. 45, Art. 376.)

Revenue Act of 1918, shall be released by the withholding agent and paid over to the person from whom it was withheld or his proper representative. With reference to how a debtor corporation may release and pay over the amount of tax so withheld in a case where a bank or other collection agency detached the ownership certificate which accompanied an interest coupon and substituted its own certificate (form 1059), which does not disclose the name and address of the bond owner, in such cases the withholding agent shall request the bank or collection agency to disclose the name and address of the owner of the bonds, as shown by the original certificate, and it shall be the duty of the bank or collection agency to make such disclosure to the withholding agent. Where withholding agents have so released any excess of tax, an itemized statement showing the names, addresses and amounts refunded should be attached to the annual list return (form 1013), in order to reconcile any discrepancy between the aggregate amount of taxes returned as shown by the monthly list returns (form 1012) and the aggregate amount as shown by the annual list return." (Reg. 45, Art. 372.)

Foreign corporations doing business in the United States must file certificate.—

Regulation. . . . . To enable debtors in the United States to distinguish between foreign corporations which have and those which have not any office or place of business in the United States, and also to enable such corporations as have an office or place of business in the United States to claim exemption from withholding the tax on bond interest or other income, a certificate, Form 1086, stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor. (Art. 601.)

Return of information as to payments to non-resident aliens.[73]—

Regulation. In the case of payments of annual or periodical income to nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. . . . . (Art. 1075; Reg. 45, Art. 1076.)

Withholding in the case of Alien Property Custodian.—

Regulation. Payments made after October 6, 1917, to the Alien Property Custodian are in the same category as payments made to or for citizens or residents of the United States. Withholding at the source is accordingly unnecessary except in the case of interest payments on corporate bonds or other obligations containing a tax-free covenant where no exemption is claimed. The Alien Property Custodian should use Form 1000 (revised) in collecting interest on bonds containing a tax-free covenant and in all other cases should use Form 1001 (revised), except that in cases in which the Alien Property Custodian shall, under the trading-with-the-enemy act, demand payment to himself of interest accrued upon bonds or other securities not yet reduced to his custody (even though they be registered in the name of an enemy, ally of an enemy, or his agent or trustee), the corporation paying such income to the Alien Property Custodian is authorized to accept from the Alien Property Custodian ownership certificates, Forms 1000 (revised) and 1001 (revised), altered by the substitution (in lieu of the certificate required thereon) of a certificate that the Alien Property Custodian is entitled to the interest entered therein with or without deduction of tax, as the case may be. No distinction

[73] See Chapter X.

is to be made between payments directly to the Alien Property Custodian and to his depositaries and between interest on registered bonds and interest on coupon bonds. In the case of enemies or allies of enemies holding a license granted under the provisions of the trading-with-the-enemy act, withholding is required as in the case of any nonresident alien not an enemy or ally of enemy. (Reg. 45, Art. 375.)

RULING. A nonresident alien enemy is not liable for tax on property taken over by the Alien Property Custodian until it is returned to him. However, he is liable to tax on such other income as was not taken over by the Alien Property Custodian and should pay the same. If the property ultimately is returned to the enemy, any income derived from the property in the hands of the Alien Property Custodian as income, would be subject to tax in the hands of the alien enemy. Such alien should make a return on the proper form, showing all sources of income in the United States and the amount thereof, whether or not it was taken over by the Alien Property Custodian.

Any tax withheld after October 6, 1917, which, under Treasury Decision 2673, was erroneously withheld, will be deemed to have been erroneously withheld up to the time of restoration of the property to the original owners by the Alien Property Custodian, but, after the restoration of the property, the tax so withheld if otherwise properly withheld in accordance with the Revenue Act of 1916, as amended, if not in excess of the tax liability of such alien, will be deemed to have been properly withheld and, if returned and paid to the Government as income tax, may be taken as a credit against the tax shown to be due by the return required for the respective year to be submitted at or after the restoration of the property by the Alien Property Custodian. (C. B. 3, page 219; O. D. 657.)

Penalties for failure to withhold.—In case of failure to make returns and payments of tax severe penalties are imposed. (See Chapter VI.)

License for collection of foreign items.—

LAW. Section 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such

regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

Regulation. Banks or agents collecting foreign items, as defined in article 1076, and required by article 1079 to make returns of information with respect thereto, must obtain a license from the Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors. The license is issued without cost on Form 1010. Foreign items shall not be accepted for collection by any bank or collecting agent so licensed unless properly indorsed or accompanied by proper ownership certificates giving all the information called for by such certificate. . . . . (Art. 1111.)

Taxation of Citizens or Residents of United States Possessions and Persons Deriving Income Therefrom

Citizens of United States possessions taxed as non-resident aliens.—

Law. Section 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources. . . . .

Regulation. A citizen of a possession of the United States (except the Virgin Islands), who is not otherwise a citizen or a resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. . . . . His income from sources within the United States is subject to withholding. . . . . (Art. 1121.)

Citizens of Virgin Islands.—

Law. Section 260. . . . . Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes," approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

REGULATION. . . . . The Act referred to in section 260 of the statute provided that income tax laws then or thereafter in force in the United States should apply to the Virgin Islands, but that the taxes should be paid into the treasury of the Virgin Islands. Accordingly, a citizen or resident of the Virgin Islands is taxed there under the provisions of the Revenue Act of 1921. (Art. 1121.)

Non-residents of Porto Rico or the Philippine Islands.—

LAW. Section 261. **That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.**[74]

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

REGULATION. (*a*) A citizen of the United States who resides in Porto Rico, and a citizen of Porto Rico who resides in the United States, are taxable in both places, but the income tax in the United States is credited with the amount of any income, war profits, and excess profits taxes paid in Porto Rico. . . . . (*b*) A resident of the United States, who is not a citizen of Porto Rico, is taxable in Porto Rico as a nonresident alien individual on any income derived from sources within Porto Rico, but the income tax in the United States is credited with the tax paid in Porto Rico. (*c*) A resident of Porto Rico, who is not a citizen of the United States, is taxable in the United States as a nonresident alien individual on any income derived from sources within the United States, and receives no such credit. . . . . The same principles apply in the case of the Philippine Islands. (Art. 1132.)

It has been held that a foreign corporation transacting business and having a place of business in both continental United States and in Porto Rico, is not subject to income tax in continental United States upon income derived from Porto Rico under the Act of September 8, 1916, as amended by the Act of October 3, 1917.[75] This avoidance of double taxation is further supported by the following regulation.

REGULATION. (*a*) A United States corporation which derives income from sources within Porto Rico, (*b*) a Porto Rico corporation which derives income from sources within the United States, and (*c*) a corporation of a foreign country which derives income

[74] For the provision of prior laws alluded to in this section, see *Income Tax Procedure*, 1921, page 1022.

[75] C. B. 2, page 260: O 976.

both from sources within Porto Rico and from sources within the United States, are all taxable in both places. In the case of the United States corporation the income, war profits, and excess profits taxes in the United States are credited with the amount of any income, war profits, and excess profits taxes paid in Porto Rico. In the case of the Porto Rico corporation there is no such credit. . . . . The corporation of the foreign country deriving income from both places is subject to no double taxation so far as the United States and Porto Rico are concerned. . . . . For the purpose of withholding, a Porto Rico corporation is a foreign corporation. . . . . The same principles apply in the case of the Philippine Islands. (Art. 1133.)

Income from sources within the possessions[76] of the United States.—In order to avoid the repetition of hardships that have resulted to taxpayers through double taxation such as existed under the law of 1918, whereby United States citizens resident in the Philippines could be taxed twice upon the same income,[77] a new section (262) has been incorporated in the 1921 law, effective from January 1, 1921. This section determines the status of citizens resident in possessions of the United States as to whether, for purposes of taxation, they could be considered non-resident aliens or residents.

Law. Section 262. (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such

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[76] Law. Section 262. " . . . . (c) As used in this section the term 'possession of the United States' does not include the Virgin Islands of the United States."

Regulation. " . . . . The term 'possession of the United States' . . . . includes Porto Rico, the Philippine Islands, the Panama Canal Zone, Guam, Tutuila, Wake, and Palmyra; it does not include the Virgin Islands." (Art. 1137.)

[77] C. B. 4, page 55; T. D. 3178.

period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another. . . .

The foregoing subsections (1) and (2) make citizens or domestic corporations having such income derived from sources within United States possessions, subject to taxation on net income computed under section 217 of the 1921 law.

In computing gross income under section 217, taxpayers, in arriving at the percentage necessary to secure the benefit of taxation under section 262, must furnish all the data concerning gross income from sources both within and without the United States. In other words, to satisfy the Commissioner as to the correctness of this assumption that they are entitled to the benefits extended by section 262, they must make a return showing their computation to be correct.

LAW. Section 262. . . . . (b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States. . . .

Section 262 (b) means that if United States citizens and domestic corporations remit amounts received in United States possessions to the United States, such amounts must be included in gross income. If taxpayers have qualified under section 262 (a) and wish to omit from gross income amounts received from without the United States, it is important that such amounts also be disbursed without the United States.

CHAPTER XXXVII

FIDUCIARIES

The sections of the 1921 law relating to fiduciaries, which differ in no essential features from that of 1918, have clarified rather than changed the provisions of the 1916, 1917, and 1918 laws.

Fiduciary defined.—A fiduciary is one who occupies a position of peculiar confidence toward others. As a general rule, a fiduciary has legal title to the property and those for whom he acts enjoy the beneficial title. The law defines a fiduciary as follows:

LAW. Section 200. . . . . **(2) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;**[1] . . . .

REGULATION. "Fiduciary" is a term which applies to all persons that occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators, and a fiduciary for income tax purposes is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, or receives and controls income of another as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary. . . . . (Art. 1521.)

It has been held that property of enemy aliens which was seized and is held by the Alien Property Custodian, cannot be said to be held in trust within the meaning of the Revenue Act

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[1] [Former Procedure] The act of 1913 included agents in the definition of fiduciaries, but as this clearly did not mean the ordinary agent or attorney, and the Treasury so held, the word was omitted from the 1916 law.

Prior to 1918, fiduciaries were considered the agents having the receipt, custody, control and disposal of non-resident alien beneficiaries' income, and as such were required to make return for such beneficiaries, and to pay any and all tax found by such return to be due, provided return was not made by the beneficiary. Since 1918 a fiduciary for a non-resident alien is required to account for any and all normal and surtax upon income paid to such a beneficiary. If this results in payment of excessive taxes, relief must be sought by filing a return and claiming refund.

of 1918.[2] The Alien Property Custodian is construed to be merely an agent or officer of the government and not a trustee or fiduciary such as is required to make returns and pay income tax. While it is held that the custodian is not required to make returns and pay tax, the Treasury, before paying out any funds representing accrual of income during retention of the alien's property by the government, may ascertain the taxes due on such income and require that they be paid.

FIDUCIARY DISTINGUISHED FROM AGENT.—

REGULATION. There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. A fiduciary relationship can not be created by a power of attorney. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the statute. In cases where no legal trust has been created in the estate controlled by the agent and attorney the liability to make a return rests with the principal. (Art. 1522.)

RULINGS. An oral agreement whereby one of a number of brothers and sisters acts as agent for all of them in managing property held by them as tenants in common under the father's will, and in distributing the income therefrom, is not a legal trust for income-tax purposes, nor is the agent a fiduciary. Each principal should file a separate return including therein his share of the income from the property and claiming a proportionate share of any allowable deductions. (C. B. 2, page 198; O. D. 425.)

By an agreement among owners of unequal portions of a royalty interest in oil and gas wells, A was appointed to receive from the purchaser of the oil and gas, moneys arising from the sale and running of the oil and gas and to account therefor to the signers of the agreement. A also had authority under the agreement to sign division orders respecting the sale and running of the oil and gas from the land. The agreement conveyed no property to A.

Held, that A is an agent of the signers and not a trustee within the meaning of the Revenue Act of 1918 and is not required to file a return on Forms 1040 or 1041 to account for the income received by him. Since the amounts paid over by him to his principals are

[2] C. B. 3, page 199; Op. A. G. 2.

not fixed and determinable gains, he is not liable for the filing of returns of information under section 256 of the aforesaid Act. . . . . (C. B. 4, page 14; O. D. 875.)

RECEIVERS ARE ALL CLASSED AS FIDUCIARIES.[3]—

LAW. Section 239. . . . . (a) . . . . **In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.[4] . . . .**

RESPONSIBILITY OF FIDUCIARY.—A fiduciary cannot be held personally responsible for erroneous or fraudulent returns by the decedent, but any additional tax arising from such returns would be a charge against the estate. It might properly be held that such a fiduciary should not make a final distribution until all past returns had been audited.

ASSOCIATION[5] DISTINGUISHED FROM TRUST.—

REGULATION. Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the cestuis que trust are liable to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have the right to hold the income for future distribution, the net income is taxed to the trustees instead of to the beneficiaries. . . . . If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute.[6] (Art. 1504.)

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[3] See footnote 22, page 1341.

[4] See page 1341 where this point is elaborated.

[5] An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. (Art. 1503.)

[6] As to Massachusetts trusts, see page 93.

It has been ruled that, under the 1916 law as amended by the 1917 law, the test as to whether or not a reorganization committee of bondholders constituted an association, depended upon the degree of control which the latter exercised over the former.

While the power to terminate a trust is not alone enough to render a trust taxable as an association, retention of substantial control over the management of the trust does operate to make the trust an association within the meaning of the law.[7]

The quesion of substantial control over the management of a trust is one of fact and there must be a clear showing in each case in order that it may be determined whether the trust is to be taxed as an association[8] or not. It was held in *Crocker v. Malley*[9] that:

> . . . . The trustees by themselves cannot be a joint stock association within the meaning of the act unless all trustees with discretionary powers are such, and the special provision for trustees in D is to be made meaningless.

How Estates and Trusts Are Taxed

Rates of tax.—

LAW. Section 219. **(a) That the tax[10] imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—**

Income subject to tax.—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

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[7] C. B. 3, page 13; Sol. Op. 49.

[8] *Cf.* Bulletins:

C. B. 1, page 5; S. 1068	C. B. 3, page 13; Sol. Op. 49
" 1, " 7; S. 1205	" 3, " 13; O. D. 654
" 1, " 9; O. D. 620	" 4, " 10; O. D. 790 and O. D. 868
" 2, " 9; S. 1337	
" 2, " 11; O. D. 407	" 4, " 11; O. D. 886
" 3, " 9; O. D. 598	B. 30-21-1741; T. D. 3193
" 3, " 10; Sol. Op. 56	B. 38-21-1830; O. D. 1040

[9] 249 U. S. 223, 63 L. Ed. 573, 39 Sup Ct. 270, 2 A. L. R. 1001.

[10] The tax referred to is the normal and surtax imposed in the case of individuals. (See Chapter VII.)

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct. . . . .

Returns by Fiduciaries

Law. Section 225. (a) That every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

When returns are required.—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate or trust the net income of which for the taxable year is $1,000 or over; and

(5) Every estate or trust of which any beneficiary is a nonresident alien. . . . .

Attention is directed to subdivision (3) in the foregoing. The statute now directs that every individual taxpayer having a *gross* income of $5,000 or more must file a return.

Regulation. Every fiduciary, or at least one of joint fiduciaries, must make a return of income (*a*) for the individual whose income is in his charge, if the gross income of such individual is $5,000 or over, or if the net income of such individual is $2,000 or over if married and living with husband or wife, or is $1,000 or over in other cases, or (*b*) for the estate or trust for which he acts, if the net income of such estate or trust is $1,000 or over, or if any beneficiary of such estate or trust is a nonresident alien. The return in case (*a*) and also in case (*b*), if the tax is payable by the fiduciary, shall be on Form 1040, or on Form 1040 A if the net income does not exceed

$5,000. In cases under (*b*) where the tax is payable by the beneficiaries the returns shall be made on Form 1041. In such a case the fiduciary shall include in the return a statement of each beneficiary's distributive share of the net income, whether or not distributed before the close of the taxable year for which the return is made. . . . If the net income of a decedent from the beginning of the taxable year to the date of his death was at the rate of $1,000 or more a year if unmarried, or $2,000 or more a year if married, or if his gross income for the same period was at the rate of $5,000 or over a year, the executor or administrator shall make a return for such decedent. . . . . (Art. 421.)

When returns are due.—

LAW. Section 227. **(a) That returns (except in the case of nonresident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months. . . .**

Exercising the authority vested in him by the foregoing section of the law, the Commissioner has granted a general extension of time up to and including May 15, 1922, in which to file fiduciary returns. This extension applies to income returns (form 1041) and information returns (forms 1099 and 1096), and is granted with respect to returns covering the calendar or any fiscal year ending in 1921.[11]

Place for filing return.—

RULING. In the case where a decedent, a resident of New York, but at the time of her decease living in California, left property in both States, an executor being appointed in each State, it is held that since the entire will was probated in New York and only that part pertaining to the property located in California was probated in that

[11] I-5-59; T. D. 3272, dated January 19, 1922.

State in conformity with its laws, the executor in California is in fact an ancillary executor and is not required to file a return for the estate, if the domiciliary executor includes in his return the entire income of the estate. (C. B. 3, page 231; O. D. 584.)

See also section 227 (b) on page 63.

Income may be computed on basis other than calendar year.[12]—

LAW. Section 212. [Individuals.] . . . . **(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; . . . .**

The section is applicable to fiduciaries, because of the definition of taxpayer given in the law, viz., "The term 'taxpayer' includes any person, trust or estate subject to a tax imposed by this Act" (section 1).

Return for deceased person to date of death.—As soon as possible after an executor or administrator enters upon his duties, he is required to make a return for the decedent up to the date of decedent's death. This is usually for the period from January 1 of the year in which the death occurred, but may be also for the preceding year, as in the case of a man dying in January or February before he had filed his annual return then due. The income tax due from the decedent is a debt against the estate in the hands of the executor or administrator, and the executor or administrator is required to file the return for the decedent in order that the amount due to the government from the decedent's estate may be determined and paid.[13]

In filing a return the executor or administrator reports all items in the manner which the decedent himself would have followed. He may claim, on behalf of the decedent, an ex-

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[12] **[Former Procedure]** Under the laws prior to the 1918 act, all fiduciary returns had to be made on the basis of a calendar year, except that returns could be made immediately upon the settlement of an estate.

[13] See T. D. 2494, June 2, 1917; also *Income Tax Procedure*, 1920, pages 869-870.

emption of $1,000, $2,000 or $2,500, as the case may be, no matter how small a portion of the year is covered by the return. And he may again claim the full exemption of $1,000 when he later reports the income of the estate for the remaining portion of a year. If the net income of the decedent for the part of the year in which he lived was less than $1,000, if unmarried, or less than $2,000 if married (provided also that his gross income was less than $5,000[14]), the executor or administrator need not make any return for him, nor is he required to account for such unreported income when he reports for the estate and its beneficiaries. Such income is entirely ignored so far as the income tax is concerned.

Regulations. As soon as possible after his appointment and qualification, without waiting for the close of the taxable year, an executor or administrator shall file a return of income for the decedent. Upon the completion of the administration of an estate and final accounting an executor or administrator shall file a return of income of the estate for the portion of the taxable year in which the administration was closed, attaching to the return a certified copy of the order for his discharge. An ancillary administrator need make no separate return if the domiciliary administrator includes in his return the entire income of the estate. Similarly, upon the termination of any other trust the trustee shall make a return without waiting for the close of the taxable year. In any such case the requirements with respect to the payment of the tax are the same as if the return were for a full taxable year closing at the end of the month during which the decedent dies or the estate is settled or the trust is terminated, as the case may be. The payment of the tax before the end of the taxable year in such circumstances does not relieve the taxpayer from liability for any additional tax which might subsequently be imposed upon income of the taxable year. . . . . (Art. 442.)

. . . . If an individual dies during the taxable year, his executor or administrator in making a return for him is entitled to claim his full personal exemption according to his status at the time of his death. . . . . If a husband or wife so dies and the joint personal exemption is used by the executor or administrator in making a return for the decedent, an undiminished personal exemption according to the status of the survivor at the end of the taxable year

[14] [Former Procedure] The qualification as to gross income was not in prior laws.

may be claimed in the survivor's return. If a taxpayer makes a return for a period other than a taxable year, the last day of such period shall be treated as the last day of the taxable year for the purpose of this article. . . . . (Art. 305.)

If the deceased person kept books on an accrual basis, all income accrued to date of death must be reported in the return made by the executor or administrator covering the period from the beginning of the taxable year to date of death. If, however, the deceased kept books on a receipt basis, only income actually received to date of his death is to be reported on the return.[15] In the case of a deceased stockholder of a personal service corporation,[16] the distributive share of the decedent in the profits from the beginning of his taxable year to date of death is to be included.[17] The same rule applies to partnership profits, and in both cases such shares would presumably be determined by prorating, if no other determination were possible. It has been held that in case a decedent had been granted an extension of time in which to file a return for a previous taxable period and later died without filing such return, the executor or administrator should file, immediately after his appointment or qualification, the return of the decedent and pay tax plus the amount of interest due on the deferred instalments.[18]

RULINGS. A taxpayer in October, 1919, converted all of his property into cash and distributed it to his wife and sister, so that at the time of his death in January, 1920, nothing remained to be administered or to satisfy his income tax liability. It is stated that the net income from the operation of his farm in 1919, together with the profit derived from the sale of his property, was sufficient to require a return.

Held, that the gift tended to defeat the intent and purpose of the income tax law and that liability for tax upon the income accruing from the sale attaches to and follows the property distributed into the hands of the recipients; also that a return for 1919 should be filed

[15] C. B. 2, page 170; O. D. 454.

[16] After December 31, 1921, personal service corporations are treated the same as other corporations, stockholders including in their individual returns only dividends actually received.

[17] C. B. 1, page 180; O. D. 52.

[18] C. B. 3, page 230; O. D. 681.

on behalf of the decedent and that the tax found to be due should be assessed against the estate of the decedent, but that demand for payment should be made upon the recipients of the gift. (C. B. 3, page 211; O. D. 582.)

In case no necessity exists for the appointment of an administrator, the beneficiaries may act jointly, or may duly appoint one of their number as the agent of the estate for the purpose of filing the income-tax return of the decedent. In doing so, however, the agent assumes the responsibility for making the return and incurs the liability to the specific penalties provided for in the case of the filing of erroneous, false, and fraudulent returns. (C. B. 3, page 229; O. D. 702.)

Returns of income to be made by fiduciaries.—

LAW. Section 219. . . . . **(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212,[19] . . . .**

REGULATION. The "period of administration or settlement of the estate" is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. Where an executor, who is also named as trustee, fails to obtain his discharge as executor, the period of administration continues up to the time when the duties of administration are complete and he actually assumes his duties as trustee, whether pursuant to an order of the court or not. . . . . (Art. 343.)

An administrator or executor may, immediately after his discharge upon final accounting, file with the proper collector of internal revenue a return covering the income and deductions of the estate for the period from the end of the last taxable year to the date of his discharge. To such a return there should be attached a certificate, under seal, setting forth the fact of the final accounting and discharge of the administrator or executor. The tax assessed against that return may be paid immediately after receipt from the collector of a notice of the amount assessed and a demand therefor. It should be under-

[19] Section 212 relates to net incomes of individuals.

stood, however, that if, upon an audit of that return, a further assessment of tax is made, the administrator or executor will be held liable for its proper payment.

One of two or more joint fiduciaries required to file return.—

LAW. Section 225. . . . . (b) Under such regulations as the Commissioner with the approval of the Secretary may prescribe, a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate or trust for which the return is made, to enable him to make the return, and (2) that the return is, to the best of his knowledge and belief, true and correct. Any fiduciary required to make a return under this Act shall be subject to all the provisions of this Act which apply to individuals.

Returns for estates or trusts which cannot be treated as units.—

RULING. Under section 219 of the Revenue Act of 1918[20] where an estate or trust represents different interests and is not susceptible of treatment as a unit, the fiduciary, in determining the distributive shares of the beneficiaries, shall analyze the items of gross income and deduction and shall (a) account as fiduciary for income held for future distribution or added to the corpus; (b) assign to the beneficiaries income which is distributable periodically; (c) report on form 1041 the net income of the estate or trust computed as a unit, but show as the distributive shares of the beneficiaries the amounts of income which should be periodically distributed to them (whether distributed or not); (d) report on form 1041 any excess of the net income of the estate or trust over the aggregate distributive shares of the individual beneficiaries as the distributive share of the fiduciary; (e) if such amount exceeds $1,000, make a separate return on form 1040 or 1040-A including such income.

The result of this will be that each beneficiary must include in computing his net income the entire sum which should be periodically distributed to him (whether distributed or not) from the estate or trust as income (other than exempt income) and no more than such sum. (C. B. 2, page 181; O. 1013.)

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[20] As the provisions of the 1918 law on which this ruling is based were re-enacted without change in the 1921 law, the ruling is fully applicable under the new law.

The application of the above principle is shown in the following:

Rulings. Under the terms of the will of a decedent a trust was created part of the income of which is distributable periodically to the beneficiaries and a portion of which is to be accumulated and added to the principal of the trust or held for future distribution. During the taxable year 1920 real estate owned by the trust was sold at a loss and the return for the trust for that year showed a net loss as a result of the sale.

It is held that the amount of the loss may be deducted from the gross income of the trust for the taxable year in computing the net income of the trust as a unit; but since the loss on the sale of the capital assets of the trust affected the corpus of the trust only, each beneficiary is required to include in computing his net income the amount of the income of the trust, if any, distributable to him, even though the aggregate of the distributive shares of the beneficiaries is larger than the net income of the trust computed as a unit. Inasmuch as there is no provision in the statute allowing one taxpayer to deduct from his gross income the losses sustained by another taxpayer and as under the statute the trust and the beneficiaries must be considered as separate taxpayers, the beneficiaries may not deduct from gross income in their individual returns for 1920 any part of the loss which was sustained by the trust through the sale of the real estate or through the sale of any other property owned by the trust. (B. 38-21-1831; O. D. 1041.)

Under a will a trust was created for the period of A's life, a part of the income of which is payable to a charitable and an educational institution and the remainder of the income to A. Upon the termination of the trust the property is bequeathed to the charitable and educational institutions. The estate received the right to subscribe for shares of stock in a corporation in which it was a shareholder and the trustee sold this right.

Held, that the trust can not be treated as a unit for income tax purposes, there being income distributable periodically and also income (according to Federal income tax statutes and regulations) which is not distributable periodically under the law of the State in which the testator resided. The trustee should file Form 1040, returning as income the amount received from the sale of the right,[21] and also Form 1041, showing the distributive shares of the bene-

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[21] Regarding the income realized from sale of rights reference should be had to the opinion of the court in the case of *Safe Deposit & Trust Co. of Baltimore v. Joshua W. Miles, Collector of Internal Revenue* (273 Fed. 822), which appears on page 550.

ficiaries in that portion of the trust income which is distributable periodically. (C. B. 4, page 226; O. D. 808.)

Return must show beneficiary's distributive share.—

LAW. Section 219. . . . . (b) . . . . **In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made.**

RULING. An executor or administrator of an estate in process of administration may not, at his option, in rendering the return Form 1040, for the estate, either claim as a deduction the amount of income properly paid or credited during the year to any heir, legatee, or other beneficiary, or compute the net income without the benefit of such deduction and pay the entire tax himself.

Held, in accordance with the provisions of Section 219, subdivision (c) and (d) of the Revenue Act of 1918, that the administrator or executor shall claim in his return, Form 1040, for the estate a deduction for any amount of income properly paid or credited within the year to any legatee, heir, or other beneficiary and that recipient must include such amount in his gross income. This applies to cases of final distribution as well as distribution made during the period of administration. (B. 27-21-1714; O. D. 967.)

REGULATIONS. In the case of (*a*) estates of decedents before final settlement, (*b*) trusts, whether created by will or deed, for accumulation of income, whether for unascertained persons or persons with contingent interests or otherwise, and in any other case within section 219(a) except paragraph 4 thereof, the income is taxed to the fiduciary as to any single individual, except that from the income of a decedent's estate there may first be deducted any amount of income properly paid or credited to a beneficiary. . . . . Where under the terms of the will or deed the trustee may in his discretion distribute the income or accumulate it, the income is taxed to the trustee irrespective of the exercise of the discretion. The imposition of the tax is not affected by the fact that an ultimate beneficiary may be a person exempt from tax. An allowance paid a widow out of the corpus of the estate is not deductible from gross income. As an intestate's real estate does not pass to his administrator, upon a sale by the heirs, whether before or after settlement of the estate, each heir is taxed individually on any profit derived. (Art. 342.)

While certain estates and trusts are subject to tax as such and others are not, the fiduciary in every case is required to make a return of income. . . . . (Art. 341.)

Returns for beneficiaries.—As a general rule, a fiduciary completes his duty as to reporting when he files form 1041. The beneficiary then files on his own behalf form 1040, including therein, among other items, the amount he has received from the estate. It should be borne in mind that, although the fiduciary may not have been required to file form 1041, because the payment to each beneficiary was less than $1,000, the beneficiary must nevertheless include the amount he receives from the estate, no matter how small, in his own return.

The fiduciary may, of course, file form 1040, for his beneficiary if he has knowledge of all the income of the beneficiary from the estate and other sources, provided he has been appointed as agent or attorney-in-fact by the beneficiary for the purpose. In doing so he acts in an entirely separate capacity, performs no duty as a fiduciary and is not thereby relieved from any responsibility as a fiduciary.

Return by guardian for minor, or committee for incompetent.—

Regulation. A fiduciary acting as the guardian of a minor having a net income of $1,000 or more, or $2,000 or more, according to the marital status of such person, or having a gross income of $5,000 or over, must make a return for such minor on Form 1040 or 1040 A and pay the tax, unless such minor himself makes a return or causes it to be made. A fiduciary acting as a guardian or the committee of an insane person having an income of $1,000 or more or $2,000 or more, according to the marital status of such person, or having a gross income of $5,000 or over, must make a return for such incompetent on Form 1040 or 1040 A and pay the tax. (Art. 422.)

When there has been a change of guardian during the year, the fiduciary in charge on the last day of the taxable year is responsible for filing the return for the full year. (I-5-58; I. T. 1185.)

Return where trustees turn property over to administrator for beneficiaries.—

Ruling. Under the terms of the will of A, creating a trust in favor of his wife which was terminated in 1920, and in accordance

with a court order, the trustees paid over to the administrators of A's estate all of the cash and property remaining in their hands after making certain payments to the heirs and legal representatives of A's wife, and the administrators in turn distributed to the beneficiaries under the will all of the cash and property which they held as administrators, including that received from the trustees. The question raised is as to how the income received in 1920 should be reported.

Held, that the trustees should file a return on Form 1041 showing the gross income of the trust and deductions claimed; also the amount of income paid over to the administrators of A's estate and any amount of such income distributed to the heirs or personal representatives of A's wife.

The administrators should file a return on Form 1040 or 1040 A, as the case may be, if the entire net income of the estate, including income received through the trustees, was $1,000 or over. In such return may be claimed a deduction for the entire amount of income received during the year by the administrators, either directly or through the trustees, and properly paid over or credited to the beneficiaries under the will. This return must be accompanied by a statement showing the names and addresses of the beneficiaries to whom income was paid during 1920, and the amount paid to each. . . . . (C. B. 4, page 223; O. D. 806.)

Return where several trusts are created by same person.—

Regulation. In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and are in charge of the same trustee, the trustee shall make a single return on form 1041 for all such trusts, notwithstanding that they may arise from different instruments. When, however, a trustee holds trusts created by different persons for the benefit of the same beneficiary, he shall make a return on form 1041 for each trust separately. (Art. 423.)

Return by trustee under revocable trust.—

Ruling. . . . . The trustee under a revocable trust is required to file a return on Form 1041, revised, in accordance with section 225 of the Revenue Act of 1918 and article 421 of Regulations 45, showing the grantor as the beneficiary under the trust. The trustee must also file a return of information on Form 1099, revised, as provided in section 256 of the Act upon which should be entered the name and address of the grantor in whose return the income should be included. (C. B. 3, page 202; O. D. 621.)

The legality of this ruling has been questioned.

Return by trustee in bankruptcy.—

RULING. A "trustee in bankruptcy" is required to file a return of net income for the bankrupt's estate if the net income exceeds the specific exemption of $1,000.

The bankrupt individual is required to file a return accounting for his individual earnings but is entitled to the exemptions provided in section 216 of the Revenue Act of 1918. (C. B. 1, page 175; O. D. 174.)

Returns by receivers.[22]—The Treasury has held that receivers in certain proceedings are required to make returns. The regulations definitely specify that receivers in partition and similar proceedings are not required to render returns of income.

REGULATIONS. A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on form 1040 or 1040A. When acting for a corporation a receiver is not treated as a fiduciary, and in such a case the return shall be made as if by the corporation itself. . . . . A receiver in charge of the business of a partnership shall render a return on form 1065. A receiver of the rents and profits appointed to hold and operate a mortgaged parcel of real estate, but not in control of all the property or business of the mortgagor, and a receiver in partition proceedings, are not required to render returns of income. In general, statutory receivers and common law receivers of all the property or business of an individual or corporation must make returns. . . . . (Art. 424.)

Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations on form 1120, covering each year or part of a year during which they are in control. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee or assignee, subject to the order of the court, such receiver, trustee or assignee stands in the

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[22] **[Former Procedure]**

RULING. The net income of a corporation in the hands of a receiver who is acting solely as an officer of the court which appointed him and subject to its orders is not taxable under the act of October 3, 1913. This ruling does not apply to the net income of a corporation in the hands of trustees or voluntary liquidators not so acting. (C. B. 2, page 222; O. 1009.)

place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. A receiver in charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income. . . . . (Art. 622.)

Ruling. Liquidating agents in charge of the affairs of a national bank should make returns for the bank for each year during which they were in control. If the bank was engaged in operating its business during a portion of a year in which the liquidating agents were in charge of its affairs, the return of the liquidating agents should include the income from such operations. Provided the taxes shown to be due by the several returns filed by the liquidating agents for the years during which they were in control, have been paid, the liquidating agents may distribute the assets of the bank, and no personal liability will be incurred by them for the payment of any additional tax that subsequently may be assessed against the bank. However, liability for any such tax follows the assets into the hands of the stockholders and other persons not creditors or purchasers for a valuable consideration. (C. B. 4, page 308; O. D. 883.)

A receiver, being relieved of his trust by the resumption of the corporation as a going concern with possession of its physical property restored to it, is also relieved of making a return for the fiscal period during which such action took place.

Ruling. A corporation on a calendar year basis, to which on December 1 is restored all its property formerly in possession of receivers, should file a corporation income and profits tax return for the calendar year, including therein the gross income received while the corporation was in the control of receivers and also the gross income received after December 1. (C. B. 4, page 308; O. D. 873.)

The Treasury has ruled that when trustees in liquidation are appointed for a corporation during a fiscal period, the trustees should file a return for the whole of such fiscal period.

Ruling. . . . . If the affairs of the company are not finally settled during the taxable year for which the return is rendered, the return of the company should be filed by the trustees in liquidation for the entire taxable year and should include the gross income received by the company prior to the time of the trustees' appointment and also the gross income received under the supervision of the

trustees. If, however, the affairs of the company are finally adjusted within the taxable year for which the return is rendered, the return of the company should be filed by the trustees in liquidation for the period from the beginning of the taxable year to the date within that year on which its transactions were finally closed. (C. B. 4, page 309; O. D. 884.)

The responsibility of filing a return rests with the receiver only when he is in fact operating the business as a business and not merely winding up its affairs.

RULING. Article 622, Regulations 45, which provides that "receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations on Form 1120, covering such year or part of a year during which they are in control . . . . " refers specifically to receivers, trustees or assignees who are operating the property or business of corporations, and it has been held that where trustees in liquidation are merely engaged in marshalling, selling and distributing the assets of a corporation they are not operating the property or business of the corporation within the contemplation of the article mentioned. It is held further, however, that where the trustees in dissolution, under the statutes of the State, as in Ohio, wholly supersede the officers of the corporation and become vested with its entire assets and control, the trustees in liquidation, and not the officers of the corporation, are the proper persons to make a return of income for the company. . . . . (C. B. 4, page 309; O. D. 884.)

Depositors who are unfortunate enough to have funds in a bank that has become insolvent, are made preferred creditors over the Commissioner of Internal Revenue:

RULING. The question is presented as to what action is to be taken with reference to the collection of taxes where banks which are in the hands of receivers owe income taxes either by way of assessments or deferred payments.

Section 22 of the Act of March 1, 1879, provides as follows:

That whenever and after any bank has ceased to do business by reason of insolvency or bankruptcy, no tax shall be assessed or collected, or paid into the Treasury of the United States, on account of such bank, which shall diminish the assets thereof necessary for the full payment of all its depositors; and such tax shall be abated from such national banks as are found by the Comptroller of Currency to be insolvent; and the Commissioner of Internal Revenue, when the facts shall so appear to him, is authorized to remit so much of said

tax against insolvent State and savings banks as shall be found to affect claims of their depositors.

In view of the above statute, no action should be taken against receivers of banks which have ceased to do business by reason of insolvency or bankruptcy until the depositors' claims have been fully satisfied. In the event that any bank has ceased to do business or is in the hands of a receiver for other reasons than insolvency or bankruptcy, the statute does not apply, and in such case proceedings may be instituted for the recovery of taxes due, notwithstanding the fact that the bank is in the hands of a receiver. (B. 32-21-1763; O. D. 990.)

Return for non-resident alien beneficiary.—

Regulation. Where a citizen or resident fiduciary has the distribution of the income of a trust any beneficiary of which is a nonresident alien, the fiduciary shall make a return on form 1040 B for such nonresident alien and pay any tax shown thereon to be due. . . . . (Art. 425.)

The authority for the requirement that the fiduciary must pay the tax in those cases in which the income has been distributed to the beneficiary is not clear. Section 225 of the law requires a fiduciary to make a return for the individual estate or trust for which he acts. If the income is being distributed, he is acting for the estate but not for the beneficiary.[23] When the fiduciary files a return and pays both normal and surtax, and such tax is in excess of the tax assessed on the alien's return of all income from sources within the United States, then relief must be sought through a claim for a refund.

Information at the source.—

Ownership certificates.—

Regulation. When fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. When bonds are

[23] **[Former Procedure]** Under the Act of September 8, 1916, as amended by the Act of October 3, 1917, the fiduciary was required to pay normal and surtax only if the non-resident alien failed to file a return.

owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners. (Art. 374.)

However, the several beneficiaries of a trust-estate are not considered joint owners of bonds in the custody of the fiduciary, and separate ownership certificates are not required.

RULING. Receipt is acknowledged of your letter dated November 1, 1921, in which it is stated that in a number of instances withholding agents have returned ownership certificates, forms 1000 and 1001, filed by you in connection with the coupons on bonds held in your various trust estates, with the request that you file separate ownership certificates for the pro rata amount of income apportionable to each beneficiary of the estate, and in other cases that you furnish a list of the various beneficiaries with their respective interests. You state that you have always complied with the provisions of Article 374 of Regulations 45 and have executed separate certificates for each estate and trust. You are of the opinion that the last sentence of that article has no reference to trust estates and that to comply with the construction placed upon this article by withholding agents would be impossible in many estates and would impose an enormous burden on the fiduciary for which there is apparently no necessity. You inquire whether this office has made a ruling requiring the interests of the various beneficiaries to be separately reported or has so construed Article 374.

There is no connection between the first and second sentences of this article. The various beneficiaries of a trust or estate are not considered joint owners of the bonds which are in the possession of the fiduciary acting for the estate or trust and to whom the income arising from such bonds is paid.

The fiduciary is required to file an ownership certificate, Form 1000 Revised or Form 1001 Revised, disclosing the identity of the estate or trust for which he acts. In connection with the collection of the income accruing to the estate from bonds issued by domestic or resident corporations, as a fiduciary acts for his principal, the estate or trust, and not for the beneficiaries of such estate or trust, this office has not ruled that a fiduciary is required to file separate ownership certificates in behalf of the beneficiaries, showing their pro rata share in the income of the estate represented by corporate bond interest.

There appears to be no reason for income tax purposes, why a withholding agent or a debtor corporation should be furnished a list of the various beneficiaries of an estate or trust, as the withholding agent or the debtor corporation is not required to pay any tax at the source in behalf of such beneficiaries, with respect to the income accruing to the estate or trust, or to furnish this office with any in-

formation relative to the beneficiaries. (Letter to the Mercantile Trust and Deposit Company of Baltimore, Baltimore, Md., signed by Deputy Commissioner E. H. Batson, and dated November 17, 1921.)

FIDUCIARIES MUST MAKE FULL RETURNS OF INFORMATION.

RULING. Is any other than a return of income required of a fiduciary?

Yes. Fiduciaries come within the provisions of section 256, of the revenue act of 1918, and will be required to render to the Commissioner of Internal Revenue a return of information, if, during the taxable year, any income has been paid to an individual, partnership, corporation, joint-stock company, etc., equal to, or in excess of $1,000. (*Income Tax Primer,* 1919, question 106.)

In accordance with the provisions of the above-mentioned section, fiduciaries are required to make returns of information regarding all payments of interest, rent, salaries, wages, premiums, annuities, compensation, remunerations, emoluments or other fixed or determinable gains, profits and income (other than payments described in sections 254 and 255) of $1,000 or more in any taxable year.[1]

This obligation is reasonable and can be readily fulfilled by fiduciaries. It is vastly simpler than the cumbersome and annoying system of deduction at the source.

It is incumbent upon fiduciaries not only to furnish the information required but also to assist as far as possible in the securing of returns from beneficiaries, so that no tax shall be lost through the abolition of deduction at the source.

Return forms.—The forms used at present are as follows:

Fiduciary return for estate...........	No. 1041
Return for minor, etc................	" 1040 or 1040A
Report of information................	" 1099
Annual information return............	" 1096
Tax withheld	" 1098
Annual return of tax withheld........	" 1042

[1] See Chapter XI for full text of this section.

Payment of Tax

When tax is payable by the fiduciary.—

LAW. Section 219. . . . . **(c) In cases under paragraphs (1), (2), or (3) of subdivision (a) or in any other case within subdivision (a) of this section except paragraph (4) thereof the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary,**[25] . . . .

The Treasury has uniformly held that income accumulated for the benefit of unborn or unascertained persons or persons with contingent interests is to be taxed to the fiduciary, notwithstanding the fact that specific provision to this effect was not included in the 1913 law. However, the 1916 law (as amended by the 1917 law) and the subsequent laws do make such specific provision.

Prior to July 26, 1915, the Treasury held that under the 1913 law this class of income was not taxable, but on that date issued the following ruling:

REGULATION. . . . . Any part of the annual income of trust estates not distributed becomes an entity and as such is liable for the normal and additional tax, which must be paid by the fiduciary. When the beneficiary is not *in esse* and the income of the estate is retained by the fiduciary, such income will be taxable to the estate as for an individual and the fiduciary will pay the tax both normal and additional. . . . . (T. D. 2231, dated July 26, 1915.)

In the case of *First Trust and Savings Bank v. Smietanka*,[26] the court held that this ruling was in error.

DECISION. . . . . This ruling was the cause of the present and other similar suits. It illustrates the not unnatural tendency of tax officers to increase the revenues by implications and strained constructions. The department's first rulings were in harmony with the natural import of the language used by Congress; its later ruling does more than violate the canon that doubts and ambiguities are to go against the government, for it is based, not upon any uncertainty in the terms of the act, but upon a metamorphosis of a body of property into a person, and upon exactions contrary to the exemptions in the Act of 1913. If the unascertained residuary legatees were now at

[25] Fiduciaries are classed as individuals, so that payments of the tax must be made as provided in the case of individuals. (See Chapter VIII.)

[26] 268 Fed. 230.

hand to receive from the trustee the accumulations of the preceding calendar year, they might be such in number as that nothing but the normal tax on the share of each in excess of his personal exemption could be assessed; but the department, by converting an estate into a personal entity, cuts off all personal exemptions and by adding the shares together subjects each share to the rates of surtaxes that are calculable on the sum total. If the residuary legatee were a charitable or educational institution, the department's method would add to the detriment due to the testator's postponement of the benefit of the taxes and surtaxes throughout the period of postponement. Congress recognized that such alterations and amendments were legislative and passed the amendatory act of September 8, 1916, levying a tax upon undistributed income added to the principal of trust estates.[27]

Liability for tax on estate or trust.—

Regulation. Liability for payment of the tax attaches to the person of an executor or administrator up to and after his discharge, where prior to distribution and discharge he had notice of his tax obligations or failed to exercise due diligence in determining whether or not such obligations existed. Liability for the tax also follows the estate itself, and when by reason of the distribution of the estate and the discharge of the executor or administrator it appears that collection of the tax can not be made from the executor or administrator, the legatees or distributees must account for their proportionate share of the tax due and unpaid. The same considerations apply to other trusts. Where the tax has been paid on the net income of an estate or trust by the fiduciary, such income is free from tax when distributed to the beneficiaries. (Art. 344.)

Income of minors taxable to fiduciary.—Where minors are concerned the procedure required of the fiduciary is outlined in the following:

Ruling. . . . . If the minor children are nonresident aliens, the fiduciary is required to make return and to pay the tax thereon, for each of the beneficiaries. If such minors are citizens of the United States, the fiduciary is required to make return for them and

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[27] **[Former Procedure]**

Ruling. Where the income of a trust fund is payable only in the discretion of the trustees, such income as the trustees in their discretion distribute to the beneficiary during the years 1916 or 1917, is taxable to the recipient personally (Act of Sept. 8, 1916, sec. 2 (b).) . . . (C. B. 1, page 176; S. 1088.)

The tax on the undistributed income was paid by the trustee.

to pay the tax, unless such minors themselves make a return or cause it to be made, provided in either instance such minors have a net income of $1,000 or $2,000 according to their marital status. In either event, the return to be made by the fiduciary for each minor child should be on Form 1040 (revised) or 1040-A (revised). (B. 44-21-1897; O. D. 1085.)

Payments to beneficiaries during period of administration not taxable to fiduciary.[28]—

LAW. Section 219. . . . . (c) . . . . **in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. . . . .**

RULING. Income of an estate during the period of administration which is not paid or credited to the beneficiary is taxable to the estate even though such beneficiary was, as a matter of law, entitled to be paid or credited with such income during that year. (C. B. 1, page 178; T. B. R. 47.)

Allowances paid to a widow under an order of court are amounts "properly paid."[29]

When income is taxed to beneficiary.—

LAW. Section 219. . . . . **(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the**

[28] **[Former Procedure]**

"The rule in New York that one who receives a bequest of the income of a specified sum, the property of the decedent being income producing at the time of his death, is entitled to such income from the date of death (*Re Stanfield's Estate*, 135 N. Y. 292; 31 N. E. 1013) has no application to interests arising under a will creating a trust of the residuary estate, and directing the payment of the income of certain portions thereof to specified individuals: The trust being created only at the expiration of administration, the right to the income of the trust fund accrues only at that time; and consequently, under the Revenue Act of 1916, no part of it is taxable to the individual beneficiary during the period of administration, but the whole of it is taxable to the estate as an entity. [Revenue Act of 1916, sec. 2 (b)] The result is the same where the will creates a right in the legatee to income from the date of the death, since such income is not payable until the completion of administration, and until that time the property producing the income is part of the estate in process of administration. Solicitor's Memorandum 783 revoked.

"Under the Revenue Act of 1918, however, the estate is entitled to deduct income properly paid or credited to legatees during the period of administration, and such income is taxable to the beneficiary. (Revenue Act of 1918, sec. 219 (c).)" (B. Digest 38-20-1206; L. O. 1051.)

[29] C. B. 4, page 224; O. D. 829.

period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. . . . .

Regulation. In the case of (*a*) a trust the income of which is distributable periodically, (*b*) an ordinary guardianship of a minor, and (*c*) an estate of a decedent before final settlement as to any income properly paid or credited as such to a beneficiary, the income is taxable directly to the beneficiary or beneficiaries. Each such beneficiary must include in his return his distributive share of the net income, even though not yet paid him, but if his taxable year is different from that of the estate or trust, then he need only include in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within his taxable year. The regulations governing partnerships are generally applicable to such an estate or trust. . . . . (Art. 345.)

Ruling. When a trust provides for the distribution of income "when received," the beneficiary should account for it personally whether distributed to him or not. The creator of the trust is not liable for income tax with respect thereto. (C. B. 1, page 180; S. 961.)

If a trust is irrevocable there can be no question but that the income is taxable to the beneficiary. If the trust is revocable the Treasury holds that the income is to be taxed to the grantor. For further discussion of this question see page 1353. As to what may, or may not, be an irrevocable trust under these circumstances is determined by circumstantial evidence as to the intent of the creator of the trust. The following is a definition given by the Solicitor to the Treasury Department as to what constituted an irrevocable trust under the laws of the state of Kentucky:

While it is essential to the creation of a trust that there be an explicit declaration of trust, or circumstances which show beyond reasonable doubt that a trust was intended to be created, no formal or

particular words are necessary, but it is sufficient if an intention to create a trust and the subject matter, purpose, and beneficiary are stated with reasonable certainty. Neither is it necessary in all cases that the creator of a trust constitute a third person trustee and transfer the legal title to him, for it is well settled that one may create a trust in his own property by constituting himself trustee, provided his words and acts clearly and unequivocally denote an intention to hold henceforth as trustee for the benefit of another.[30]

Income of discretionary trust taxable to trustee.[31]—

Ruling. Where the income of a trust fund is payable only in the discretion of the trustees, such income . . . . as is received in 1918 or later years by the trust estate is taxed to the trustees irrespective of the exercise of their discretion. (C. B. 1, page 176; S. 1088.)

As in the application of the estate tax law (q. v.), so with the income tax law, consideration must be given to the laws dealing with the subject of trustees which obtain in the state wherein the estate is situated and which may govern the situation.

It should be noted that the income on which the trustees had paid the tax is tax-free when received by the beneficiaries.

The constructive creation of a trust whereby a beneficiary becomes a fiduciary is shown in the following:

Ruling. A father and son, having acquired from an intestate a life estate and vested remainder respectively in real property in New York, made a joint conveyance of the property for an amount in excess of its value when acquired by them. The proceeds of the sale were placed in a bank in the father's name and they agreed that the father should have the income from the fund for life and upon his death that the principal should go to the son.

Under the laws of the State of New York and by the weight of authority generally, the father is a trustee for the remainderman, his son. The profit derived from the sale represents the undistributable

[30] C. B. 4, page 108; A. R. R. 492.

[31] **[Former Procedure]**

Ruling. Where the income of a trust fund is payable only in the discretion of the trustees, such income as the trustees in their discretion distribute to the beneficiary during the years 1916 or 1917, is taxable to the recipient personally (Act of Sept. 8, 1916, sec. 2 (b).) . . . . (C. B. 1, page 176; S. 1088.)

The tax on the undistributed income was paid by the trustee.

income of a trust entity, and the trustee should file a return on Form 1040 showing the profit from the sale. . . . . (B. Digest 38-21-1830; O. D. 1040.)

Residuary legatee pays tax—when?—

Ruling. Inasmuch as a residuary estate is the gross estate of the decedent less proper expenses and bequests of specific amounts or specific property, and the specific bequests must be paid in full after all debts and expenses are paid, even though nothing remains to constitute a residue, it follows that if an estate is distributed and no provision made for any part of such expenses or specific bequests, a proper residue is not obtained and the residuary legatee has received an amount in excess of that to which he is entitled. Therefore, where the estate of a deceased person has been settled, no provision being made for the payment of income tax, the tax assessable is properly collectible from the residuary legatee. (C. B. 3, page 211; O. D. 722.)

Income of each trust separately taxed.—

Ruling. Where the same trustee is designated in a will to administer several trusts, the accumulated income of each separate trust will be taxable as an entity, not the income of the trusts combined. (C. B. 1, page 175; O. D. 316.)

Grantor taxable on income of revocable trust.—

Regulation. . . . . The income of a revocable trust must be included in the gross income of the grantor. (Reg. 45, Art. 341.)

The foregoing regulation is of interest to taxpayers who have created revocable trusts on the assumption that the tax on the income from the trust will be imposed upon the beneficiary.

Rulings. Where a declaration of trust provides that during the life of the donor he may indicate the manner in which the trustee shall exercise the powers conferred by the trust agreement; that the donor shall have a voice in determining the amount of net income to be distributed to the beneficiaries; and that the estate created and the interests vested thereunder shall be subject to revocation by the donor at any time, in whole or in part, it is held that the amount of income received by the beneficiaries is in the nature of a gift, and that the trustee merely acts as agent for the donor. The income of the trust should therefore be included in the gross income of the donor in accordance with article 341 of Regulations 45. . . . . (C. B. 3, page 202; O. D. 676.)

Where a person transfers funds or property to trustees to pay to him during his lifetime so much of the income as he may demand, and from time to time as much of the principal as such trustees might deem advisable, all unwithdrawn income at the date of the death of the settlor to become a part of the trust fund, the settlor should return in any one year all the income accruing from such trust fund, whether actually withdrawn by him or not.

The trustees under such deed must make return of all income from the trust, but are relieved from paying a tax thereon. . . . .[32] (C. B. 2, page 176; S. 1344.)

A devised to B a life estate in property coupled with a power of disposition. B exercised the power by an indenture creating an irrevocable trust in her right and interest in A's estate. The trust instrument by reference incorporated and made a part thereof B's will for the purpose of providing for the distribution of the trust fund after her death and the designation of the beneficiaries, corporations exempt from taxation.

The Committee is of the opinion that the title of the beneficiaries vested upon the delivery of the trust property to the trustees, and that the income accruing to the trust fund from the date of the death of the creator of the trust to the date of the distribution of the trust fund is not taxable in the hands of the trustees. The Committee recommends that a return should be made by the trustees on Form 1041, taking as a deduction all amounts paid to or permanently set aside during the taxable year for the exempt corporations. . . . . (C. B. 4, page 221; A. R. R. 521.)

The theory of the regulation is that it is a gift. If the grantor in such cases were permitted to exclude such income from his gross income, it would result in "wholesale" evasions of taxes, especially where taxpayers are subject to high surtax.

A reasonable doubt exists in the case of some revocable trusts as to the taxable status of grantor and grantee when the grantor conveys and delivers property to a trustee and the latter has sole control over principal and income and no revocation is made prior to the end of the taxable year. It is true that the trustee is an agent, but he is an agent for the grantee as well as for the grantor. Upon the collection of income,

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[32] This ruling applied to a case arising under the 1916 law as amended by the 1917 law, but the same principle doubtless governs under the present law.

title thereto vests in the trustee in trust for the grantee. The question is: "What did the trustee collect?" It would seem that in the absence of revocation up to the date of collection the sole beneficial interest rests in the grantee and the income collected can hardly be said to have been income of the grantor, even constructively or in the hands of his agent. Any act of the grantor must be performed before income arises; therefore failure to act would seem to destroy the agency theory. Certainly if income such as interest and rents which accrue from day to day vests in the trustee in trust for the grantee and becomes the sole property of the grantee, even though the trust is revoked and the principal is withdrawn there is room for argument that such income as accrues to the grantee is taxable income and should not be included in the return of the grantor.

No specific ruling is available as to the status of revocable trusts when there are several creators. Presumably the same general principle would govern.

Tax payable by estates of non-resident aliens.[33]—

Rulings. . . . . 1. The undistributed net income of a trust estate under the control of a resident fiduciary and subject to the jurisdiction of a state or territory of the United States, or of the District of Columbia, is taxable in the same manner as income accruing to an unmarried resident individual, irrespective of the fact that the creator of the trust may be a nonresident alien and irrespective of the fact that the ultimate beneficiaries may be nonresident aliens. The exemption to which a single person is entitled may properly be claimed regardless of the citizenship or residence of the creator or of the trust of the beneficiaries for whom the income is retained.

2. The income of an estate in process of administration in the courts of a state or territory of the United States or of the District of Columbia by resident fiduciaries is taxable as an entity, irrespective of the fact that the decedent may have been a nonresident individual and the beneficiaries or distributees may be nonresident aliens and the income may be, in part or in whole, derived from foreign sources. The same specific exemption may properly be claimed as provided for under (1) above. The income taxable to the estate is determined after applying the provisions of section 219 (c).

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[33] See Chapter XXXVI for discussion.

3. Nonresident alien fiduciaries of trusts subject to the jurisdiction of a foreign country are taxable on undistributed net income from sources within the United States, irrespective of the fact that the creator of the trust or estate may be either a citizen or resident of the United States or a nonresident alien and the beneficiaries may be either citizens or residents of the United States or nonresident aliens. An exemption allowed a single person may properly be claimed, provided the fiduciary is a citizen or subject of a country which imposes an income tax and allows a similar credit to citizens of the United States not residing in such country.

4. The income of estates in process of administration in the courts of a foreign country by nonresident alien fiduciaries is taxable as an entity in so far as the income received is from sources within the United States, irrespective of the fact that the decedent may have been either a nonresident alien or citizen of the United States and the beneficiaries in the distribution may be either nonresident aliens or citizens or residents of the United States. The same specific exemption as provided for in (3) above may be claimed under the same conditions and limitations. (C. B. 2, page 172; A. R. M. 37.)

The net income of a discretionary trust which was created by a nonresident alien for the benefit of another nonresident alien is taxable in the hands of a resident fiduciary who is subject to the jurisdiction of a State or Territory of the United States, or the District of Columbia, notwithstanding such income is derived from interest on the bonds of foreign governments and foreign corporations, where the income is not otherwise exempt under the provisions of section 213 (b) of the Revenue Act of 1918. (C. B. 3, page 203; O. D. 743.)

Estate of an enemy alien.—

Ruling. During the period of administration it is the duty of the administrator or executor to make return and pay whatever may be due on income received by the estate of a deceased person. The demand of the Alien Property Custodian for the interest of the beneficiary, who is an alien enemy, entitles the Alien Property Custodian to receive from the administrator or executor the net amount found to be due by the court administering the estate to the alien enemy. After the distribution and receipt by the Alien Property Custodian of the enemy's share in the estate no further tax can be required to be reported or paid by the Alien Property Custodian. However, up to the date of the distribution of the estate it is incumbent upon the administrator or executor to report and pay the income tax due on the estate, the Alien Property Custodian being concerned only with the net amount found to be due the enemy on distribution. In case the property of the enemy is ultimately returned to the enemy such

part of the property as represents income of the property taken over by the Alien Property Custodian would be subject to a tax in the hands of the enemy. The question how this shall be collected is a matter of procedure between the Alien Property Custodian's Office and the Internal Revenue Bureau.[34] (C. B. 3, page 203; O. D. 598.)

Withholding the tax.[5]—The duties of a fiduciary as withholding agent are twofold. On payments to non-resident aliens of rent, salary, interest on debts of the estate and of other fixed or determinable annual or periodical income, he acts in the capacity of a withholding agent and, like any other payer of similar income, he is authorized to accept the same ownership certificates and is required to file the same annual list returns. For a description of his duties in this capacity, see pages 297 and 314, dealing with the collection of the tax at the source on miscellaneous income payable to non-resident aliens.

In his capacity as a fiduciary, when he pays the net income or profits of the estate to the non-resident alien beneficiaries he proceeds as indicated on page 1300 of Chapter XXXVI, "Non-Resident Aliens." It is not his duty to deduct the tax on payments to citizens or resident beneficiaries. When the fiduciary pays over any part of the principal or corpus of the estate no tax is due. The tax is deducted only on income payments. Property coming to the estate by gift, bequest, devise or descent may be distributed among the beneficiaries without regard to the tax, since such income is expressly declared to be exempt from the law. Gains or income from such property, however, are taxable.

On payments to non-resident aliens the tax should be deducted regardless of the amount paid. A non-resident alien by filing a complete return of income from sources within the United States may secure the benefit of the personal exemption, if entitled thereto. (See page 1295.)

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[34] See Chapter XXXVI.

[5] [Former Procedure] The previous provisions of law, requiring fiduciaries to withhold the tax at the source, were repealed on October 3, 1917, except as they applied to non-resident aliens.

No penalty for delay in payment in certain cases.—

LAW. Section 250. . . . . (e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: . . . .

Determination of Income Taxable to Fiduciaries and to Beneficiaries

There has been included in the 1921 law an additional subdivision to section 219. This addition summarizes the apportionment of the income of an estate or trust when such income arises from various sources.

LAW. Section 219. . . . . (e) In the case of an estate or trust the income of which consists both of income of the class described in paragraph (4) of subdivision (a) of this section and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with subdivision (b) and the tax shall be imposed, and shall be paid by the fiduciary in accordance with subdivision (c), except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in paragraph (4) of subdivision (a) which, pursuant to the instrument or order governing the distribution, is distributable during its taxable year to the beneficiaries. In cases under this subdivision there shall be included, as provided in subdivision (d) of this section, in computing the net income of each beneficiary, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable during the taxable year to such beneficiary. . . . .

The foregoing covers the procedure when income includes items taxable to both fiduciary and beneficiary. The method prescribed may be summarized as follows:

1. The *fiduciary* computes net income in same manner as for an individual, except that deductions may be made,
   (a) For gifts directed by the will or trust instrument without limitation.

(b) For amounts properly *paid or credited* to heirs, legatees, or beneficiaries.

2. The *beneficiary* computes net income as to such items in (a) and (b) above as apply to heirs.

For convenience it will be desirable to discuss the determination of net taxable income in the following cases:

1. Income of a deceased person to date of death.
2. Income of an estate in the process of administration.
3. Income when definite trusts have been created.
4. Income paid to non-resident aliens from resident and non-resident estates and trusts.

Determination of net taxable income during administration of an estate.—

REGULATION. . . . . No taxable income is realized from the passage of property to the executor or administrator on the death of the decedent, even though it may have appreciated in value since the decedent acquired it. In the event of the delivery of property in kind to a legatee or distributee, no income is realized. Where, however, the executor sells property of the estate for more than its value at the death of the decedent, the excess is income or may be capital gain taxable to the estate. . . . . (Art. 343.)[36]

RULING. A died testate in 1917 and his widow qualified as administratrix with the will annexed in 1918. The entire estate was left to the widow with the exception of 10x dollars which was bequeathed to B. The legacy given to B was paid in 1918 and during that year all debts, taxes and costs of administration were paid in full and the widow, as sole beneficiary, reduced whatever remained to her possession as her personal estate. All the income of the estate since the decedent's death has been reported by the widow in her individual returns. Upon making final report and settlement in 1921 a court order was issued discharging the widow from liability as administratrix.

Held, that inasmuch as the estate of A was in the process of administration until 1921, the widow as administratrix, is required to file a return for the estate for each of the periods from the date of the decedent's death to December 31, 1917, January 1, 1918, to December 31, 1918, January 1, 1919, to December 31, 1919, January 1,

[36] For definition of "period of administration," see balance of Art. 343, quoted on page 1335.

1920, to December 31, 1920, and January 1, 1921, to the date of her discharge, during which the net income of the estate equaled or exceeded $1,000. The return for the period from the date of the decedent's death to December 31, 1917, should be on Form 1040 or 1040A, and the administratrix will be required to pay the tax which may be assessed on the basis of such return. In the event the income of the estate for any of the other periods in question was $1,000 or more as computed without deducting the amount paid or credited to the beneficiary, returns covering such periods should also be made on Form 1040 or 1040A, as the case may be. The returns should be accompanied by a statement showing that during each period the entire net income was paid or credited to the widow as sole beneficiary. . . . . (C. B. 4, page 225; O. D. 926.)

The net income of an estate in the process of administration is ordinarily determined on the same basis and in the same manner as in the case of a single individual,[37] except that a credit is allowed for any payments made to a beneficiary and the deduction for charitable contributions (paid or set aside "pursuant to the terms of the will or deed creating the trust"[38]) is not limited to 15 per cent, as in the case of individuals. Income ordinarily exempt when received by individuals, such as proceeds of life insurance,[39] municipal and other exempt bond interest, etc., is also exempt when received by an estate.

A decedent contracts for the sale of certain property and receives, during his lifetime, earnest money binding the contract. After his death and during the period of administration the sale is consummated, title passes and possession is taken by the purchaser. Held that no income accrues from the transaction to either the decedent or the estate.[40] The reason is obvious. No completed transaction occurred during decedent's lifetime; he merely received the cash deposit and retained title to the property. The property, with the con-

[37] Estates taxed as entities are allowed an exemption of $1,000 only.

[38] Section 219 (b).

[39] **[Former Procedure]** Under the 1916 and 1917 laws all proceeds of life insurance policies payable to others than the individual beneficiaries were taxable (section 4). The 1913 law (section B) stated that net income should not include "the proceeds of life insurance policies paid upon the death of the person insured."

[40] C. B. 4, page 224; O. D. 807.

tract, passes to the estate of the decedent at his death and is valued for inclusion in the corpus of that estate at the sale price agreed upon by the decedent. When the balance of the purchase money is paid there is no difference between the value of the property on the books of the estate and the amount received therefor. Consequently no gain or loss is realized.

Current expenses incurred in the management of an estate may be deducted, but the initial expenses may not. The Treasury makes a distinction between such first expenses of the estate as are properly chargeable against the corpus or principal of the estate and to that extent reduce the size of the estate, and other management expenses arising from the nature of the properties and details of the business, which are properly deductible from the year's gross income.

RULING. Executors who continue the trade or business of the decedent may deduct from the gross income of the estate, in computing its net income, all ordinary and necessary expenses paid or incurred during the taxable year in continuing such trade or business, but may not deduct expenses of administration.

The amounts which may be deducted as salaries or other compensation for personal services are limited to a reasonable compensation for personal services actually rendered in continuing the trade or business of the decedent. . . . . (C. B. 4, page 119; Sol. Op. 88.)

REGULATION. . . . . Expenses of the administration of an estate such as court costs, attorney's fees and executor's commissions, are chargeable against the corpus of the estate and are not allowable deductions. . . . . (Art. 293.)

An assessment levied on bank stock owned by decedent is held by the Treasury to be additional cost of such stock and not a deductible loss.

RULING. An assessment of 100 per cent on the par value of bank stock paid by the executor of the estate of a deceased stockholder in fulfillment of a statutory liability is not deductible from the gross income of the estate. The amount so paid should be added to the fair market value of the shares as at the date of the testator's death and the resultant sum used as a basis in determining gain or loss realized upon final disposition of the shares of bank stock by the executor. . . . . (C. B. 4, page 213; O. D. 918.)

Gain or loss from sale of stock received as stock dividend.—The manner of determining gain or loss from the sale of stock acquired as stock dividend is fully discussed and exemplified in Chapter XXXIII.

The taxability of the income of a trust estate arising from such a source is dealt with in the following ruling:

RULING. . . . . If the income of the trust estate is distributable periodically, including any profit realized on the sale of such capital assets belonging to the estate, any gain realized from the sale of such capital assets is taxable income to the beneficiaries regardless of whether distributed or not. If the income of the trust estate is not distributable or is distributable in the discretion of the trustee, any profit realized from the sale of capital assets is taxable in the hands of the trustee regardless of whether distributed or not. As will be noted from Article 1547 of Regulations 45, any loss sustained on the sale of capital assets is available as a deduction only to the fiduciary of the estate or trust in determining the income of the estate or trust taxable to the fiduciary and such loss is not available to the beneficiaries who are taxed on their actual distributable income. In the case of stock received as a stock dividend being distributed to the beneficiaries by the fiduciary, this would constitute a distribution in kind of the property of the estate and no taxable gain or deductible loss results to the beneficiaries until such stock is sold or otherwise disposed of by them. (Letter to the Safe Deposit and Trust Company, Baltimore, Maryland, signed by E. H. Batson, Deputy Commissioner, dated December 8, 1921.)

Federal estate tax deductible.—Contrary to former procedure[41] and in keeping with the following decision of the United States Supreme Court,[42] federal estate tax is now deductible from the income of the estate in the year when such tax becomes due.

RULING. Federal estate tax paid by executors of an estate is an allowable deduction, under section 214, in ascertaining the net taxable income of the estate for the year in which said estate tax "accrued," which means became due. (C. B. 4, page 153; T. D. 3195.)

The decision is based entirely on the fact that when the

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[41] **[Former Procedure]** Reg. 45 (1918), Art. 134: " . . . . Federal estate taxes are not deductible."

[42] *U. S. v. Woodward*, Supreme Court, June 6, 1921, advance opinions, 65 L. Ed. 728.

1918 income tax law was promulgated it provided for the deduction of "taxes paid or accrued within the taxable year imposed (a) by the authority of the United States except income, war profits, and excess profits taxes."[43] At the time of such promulgation an estate tax was in existence and, further, was reimposed in Title IV of the 1918 law itself. No steps were taken to make the estate tax a non-deductible item from gross income; therefore it is logical to assume that Congress did not intend to exclude it.

In view of this decision, executors and administrators who have filed returns since September 9, 1916, (the effective date of the 1916 law) without claiming the federal estate tax as a deduction for the year in which it became due, should file a claim for refund or credit. In this connection, however, due notice must be taken of the limitations imposed by the various laws on claims for refund.

Other taxes.—Taxes or assessments for local benefits are not ordinarily deductible.[44] It has been held that where such taxes are paid by a tenant on behalf of, and under agreement with, his landlord, they may be considered as additional rent paid by the tenant.[45] When such rent is a business expense the item would, therefore, be deductible in determining net taxable income.

Unrealized losses not deductible by the estate.—

RULING. A loss can not be claimed in a return rendered for a decedent covering the taxable period to the date of his death where the cost of securities, or their fair market value as at March 1, 1913, if acquired prior thereto, is in excess of the value established by appraisal for the purposes of administering the estate, except in the case of a decedent who was a dealer in securities and regularly inventoried his securities and made his return accordingly. The executor should not make returns of book gains or losses, either up to the date of death or on transfer of the property to the legatee or to

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[43] 1918 law, section 214 (a-3).
[44] Law, section 214 (a-3) and (c).
[45] Digest 11, page 116; O. D. 373.

a trustee under the will, or from one trustee to a succeeding trustee, the appraised value remaining as the basis for computing all subsequent realizations of losses or gains in cash. (C. B. 1, page 180; O. D. 219.)

In Chapter XXVI, "Deductions for Expenses," deductions for exhaustion of the principal of life or other terminable interest acquired by gift, bequest, or inheritance are discussed, particularly having regard to section 215 (b) of the 1921 law, which specifically forbids such deductions by beneficiaries of such interest.

Expenses connected with sale of property deductible—when?—

RULING. An executor who pays to another, as agent, a commission upon the sale of property belonging to the estate may deduct from the selling price the amount so paid in determining the gain or loss arising from the sale.

An executor who retains as his commission a portion of the amount received by him from the sale of property belonging to the estate may not deduct the amount in preparing a return for the estate since any service performed by him in that connection is deemed to be a part of his duties as executor. Such a commission, however, should be included in the gross income reported in the executor's personal return for the year in which received.

Where property owned by an estate is sold, the amount of the stamp tax upon the deed conveying title to the property constitutes an allowable deduction in the return of the estate. (C. B. 3, page 204; O. D. 632.)

Deduction for depreciation.—In the illustration in article 347 neither the estate as a unit nor the beneficiary receives credit for the actual depreciation. The following quotation from Bulletin "F" indicates a more logical solution, viz., that whether or not the estate is treated as a unit, depreciation will be allowed.

RULING. An individual who receives income from a trust estate may not deduct from gross income in his individual income tax return any amount representing depreciation of property belonging to the estate. However, under the Revenue Act of 1918 it is permissible for the fiduciary in ascertaining the net income of the estate

or trust for which he acts to deduct a reasonable allowance to cover the depreciation sustained during the taxable year, whether or not the terms of the will or agreement creating the estate or trust or a decree of court provide for taking care of the depreciation which may be sustained on the property held in trust.

Estates and trusts in certain circumstances are treated as units and in other cases may represent aggregates of distinct interests, to all of which the fiduciaries are responsible. Irrespective of whether the estate or trust is or is not treated as a unit, the fiduciary in computing the net income upon which he is required to pay the tax may claim a deduction for depreciation in accordance with section 214 (a) 8 Revenue Act of 1918 and articles 161-171 Reg. 45. See also T. D. 2987. (Bulletin "F," page 32.)

Deductions for net losses.—The provisions in section 204 of the 1918 law for the deduction of net losses sustained during any taxable year ended October 31, November 30, or December 31, 1919, has, with some modification, been revived in the new law and made effective from January 1, 1921. Under the 1918 law the net loss arrived at in accord with the requirements of this section was deducted from the prior year's income, so far as such income permitted, and the balance, if any, was deductible from the following year's income. The 1921 law, however, assigns all deductions in this respect to future years only.[46]

LAW. Section 204. . . . . (c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, ...

(d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

The benefit is extended to beneficiaries, as such. Assume a year's income from an estate during the period of administration to be made up as follows:

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[46] See page 1021.

Net income from investments	$60,000
Loss on operation of decedent's business........	20,000
Net income of estate	$40,000

Under the terms of the will the income from the investments was to be distributed among two beneficiaries in equal shares. The earnings of decedent's business went to a third beneficiary and formed his only source of income. The first two beneficiaries receive their $30,000 each; the latter receives nothing, since there were no earnings from the business, but a loss instead. Under section 204 of the law, however, the $20,000 loss will be deductible in the two succeeding taxable years to the extent that the income during those years shall be sufficient to equal the loss.

The inclusion of beneficiaries specifically in this provision is intended to remove any question that might otherwise arise as to their status in relation thereto. A fiduciary who carries on the regular business of the decedent and distributes the income therefrom to beneficiaries as and when received, would not be subject to tax. The beneficiaries pay the tax under such circumstances.[47] Without the provision under discussion it might technically be held, under these conditions, that the law did not permit of the deduction by a beneficiary of net losses.

Deduction for contributions.—

Law. Section 219. . . . . **(b) . . . . except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. . . . .**[48]

Ruling. The amount of undistributed net income which is retained and permanently set aside for certain charitable and educa-

[47] Law, section 219 (d).
[48] Section 214 (a-11) refers to deduction for contributions.

tional organizations designated by the will of a decedent, which were in existence at the time such income was permanently set aside, and was then reinvested for the estate, falls within the meaning and intent of part of section 219 (b) of the Revenue Act of 1918.[49] . . . .

Therefore the income so permanently set aside, retained, and invested by the executors and trustees is not subject to tax. This does not, however, apply to income set aside for the benefit of an organization not fully in existence, as to which no deduction is authorized.[50] (C. B. 3, page 203; A. R. R. 280.)

The foregoing ruling, which applies to the 1918 law, was evidently based upon a recent case[51] decided by a Circuit Court of Appeals under the laws prior to the 1918 act. The facts in this case were as follows:

Decision. By his will Alexander J. Derbyshire, who died in 1879, devised his residuary estate to "the contributors to the Pennsylvania Hospital," a corporation of Pennsylvania created for charitable uses and purposes, and no part of the net income thereof is for the benefit of any private stockholder or individual. The devise was subject to the payment to certain annuitants, all of whom, save one, have died. The residuary estate amounts to several hundred thousand dollars, its annual income is substantially $15,000 and upwards, and the remaining annuity is for a few hundred dollars per year. The construction of the will came before the Supreme Court of Pennsylvania in Biddle's Appeal, 99 Pa. 525, wherein the title to the residuary estate was adjudged vested in the hospital. . . . .

It will thus be seen that, while the residuary estate remains theoretically and for purposes of accounting in the hands of the trustee, it is already in the possession of the hospital in the shape of money loaned on mortgage, and upon such loan the hospital is paying to the trustee only such interest as takes care of administrative charges and the surviving annuity. Under such circumstances, the collector assessed and collected, under protest, from the trustee on June 26, 1917, the sum of $4,273.42, being on the income of the residuary estate for the years 1913, 1914, 1915, and 1916, and on June 11, 1918, an income and excess profit tax of $6,842.02 upon the income of the residuary estate of 1917. It is, of course, apparent the trustee has no financial interest in the residuary payment, and while this large

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[49] Section 219 (b) of the 1921 law is similar to the like numbered section of the 1918 law.

[50] C. B. 1, page 175; O. D. 278.

[51] *Lederer v. Stockton*, 266 Fed. 676; certiorari granted October 25, 1920, 254 U. S. 625.

sum is in theory assesssed as a tax on income received by the trustee or the testator's estate, the whole sum is paid at the expense, and from the property, of the hospital. The question, then, in substance and practice, resolves itself into this: Is this hospital liable for income tax? . . . .

The court, in deciding that no tax was due, said:

Decision. . . . . From the above, it is clear to us, first, that the United States, the taxing power and real defendant in this case, speaking by its legislative branch in plain language enacted its purpose and will to exempt from taxation the income of "any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual;" second, that the action of the United States by its executive officer, in this case the collector of internal revenue, in assessing and collecting this income tax from the hospital, was not warranted by the taxing statutes; and, third, that it is the duty of the United States, acting by its third agency, the federal courts, to prevent its executive branch from illegally defeating its expressed will in the law enacted by its legislative branch.

The sentence in article 342 of Regulations 62 which provides that "the imposition of the tax is not affected by the fact that an ultimate beneficiary may be a person exempt from tax" appears to be in conflict with the decision in the foregoing case and with the following ruling:

Ruling. A testator bequeathed and devised property to trustees to pay a part of the income therefrom to A during his life. The will provided that upon A's death the rest and residue of the estate, together with any accumulated income, should go to a municipality in perpetual trust to hold the same as a permanent trust estate and fund, the income from which was directed to be used exclusively in the exercise of a normal governmental function.

Held, that the income received by the trustees under the will other than that distributed to the annuitants named in the will is not taxable in the hands of the trustees under the Act of October 3, 1913, the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918. . . . . (B. 28-21-1724; O. D. 972.)

When executor is obligated to estate.—

Ruling. Amounts paid by an executor of an estate, out of his personal funds in discharge of obligations of the estate, such amounts

being credited against the executor's liability for interest to the estate, are nevertheless income to the estate to the extent that they represent interest accrued since the death of the testator on obligations of the executor to the estate. (C. B. 1, page 175; O. D. 51.)

Credits allowed when tax is payable by the fiduciary.—

LAW. Section 219. . . . . **(c) . . . . In such cases** [paragraph(1), (2) or (3) of subdivision (a)] **the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.**[52] . . . .

REGULATION. (*a*) An estate or trust taxed to the fiduciary is allowed the same credits against net income as a single person, including a personal exemption of $1,000, but no credit for dependents. (*b*) In the case of an estate or trust taxed to the beneficiaries each beneficiary is allowed for the purpose of the normal tax, in addition to his individual credits, his proportionate share of such dividends as described in Article 301 and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the estate or trust. Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. . . . . (Art. 346.)

Credit for taxes.—

LAW. Section 222. **(a) That the tax computed under Part II of this title** [Income Tax] **shall be credited with: . . . .**

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.[53] . . . .

Taxable income when trusts have been established.—If the income from an estate or trust is held for distribution to unborn or unascertained persons or persons with contingent

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[52] The credits so specified in section 216 are: (1) dividends, (2) interest on United States government bonds and bonds of the War Finance Corporation, (3) an exemption of $1,000. See Chapter XX for determination of taxable Liberty bond interest.

[Former Procedure] The specific exemption allowed to estates under the acts of 1913 and 1916 was $3,000. In 1917, two specific exemptions, one of $3,000 and one of $1,000, were permitted. Under all acts, if the income of the estate or the amount payable to any beneficiary was less than the exemption, no return was required from the fiduciary.

[53] See Chapter XXVIII for discussion of this credit.

interests and there is no periodic distribution of income, the net taxable income is determined in substantially the same manner as is prescribed for estates in the process of administration. If, however, income is distributed periodically to beneficiaries or part is distributed and part held in trust, the determination of the taxable income of the estate or trust and of the beneficiaries becomes a more difficult problem. Following is the latest Treasury regulation on this subject:

Estates or trusts which cannot be treated as units.[54]—

REGULATION. In the case of an estate or trust, the income of which consists both of income to be distributed to beneficiaries periodically and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with section 219 (b)[55] and the tax shall be imposed and paid by the fiduciary in accordance with section 219 (c),[56] except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in section 219 (a) (4)[57] which, pursuant to the will or trust deed, is distributable during its taxable year to the beneficiaries. Each of such beneficiaries shall include, in computing his net income, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to him during the taxable year. (Art. 347.)

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[54] **[Former Procedure]**

REGULATION. In the case of a trust estate where the terms of the will or trust or the decree of a court of competent jurisdiction provides for keeping the corpus of the estate intact, and where physical property forming a part of the corpus of such estate has suffered depreciation through its employment in business, a deduction from gross income for the purpose of caring for this depreciation, where the deduction is applied or held by the fiduciary for making good such depreciation, may be claimed by the fiduciary in his return of income. Fiduciaries should set forth in connection with their returns the provision of law, trust, or decree requiring such depreciation deduction where any exists or when actual depreciation occurs, the amount thereof, and that the same has been or will be preserved and applied as such. All amounts paid by fiduciaries to beneficiaries of trust estates from the income of such trust estates, whether from reserves or otherwise, are held to be distributions of income and will be treated for income-tax purposes in accordance with the provisions of law and regulations applicable to income of such beneficiaries. (Par. 199, Reg. 33; the 1916 and 1917 laws.)

[55] See page 1335.

[56] See page 1347.

[57] See page 1329.

An example of the application of the provisions of the foregoing regulation was contained in an amendment to the article of the 1918 regulations dealing with the same subject.

RULING. . . . . For example, a trust is created the income of which is distributable periodically for the life of the beneficiary, the remainder over to others. The trust has the following items of income. Rent, $3,000; interest, $2,000; gain on sale of capital assets, $1,500; cash dividend, $1,000; and deductions, general expenses (all deductible from distributable income), $700; depreciation, $300; loss on sale of capital assets, $3,000. Under the terms of the trust $5,300 will be distributed to the beneficiary, viz., rent, $3,000; plus interest, $2,000; plus dividend, $1,000; less general expenses, $700. The gain and loss on the sale of capital assets will be considered capital items affecting the corpus only, and the items of depreciation will not affect the amount to be distributed, there being no rule of State law or provision of the trust requiring this deduction from distributable income. In such a case the fiduciary must report on form 1041 showing a net income for the trust of $3,500, and must show as the distributive share of the beneficiary the $5,300 to which he is entitled. The beneficiary must account for the amount actually distributable to him as income, viz., $5,300, as provided in section 219 (*d*) and will be entitled to a credit of $1,000 on account of the dividends in computing the normal tax, but not to any deduction on account of depreciation or capital losses.

If there had been no loss on the sale of capital assets so that the net income of the estate or trust was $6,500, Form 1041 should show the distributive share of the beneficiary as $5,300, and the distributive share of the fiduciary as $1,200; and the fiduciary should file a separate return on Form 1040 A, reporting $1,200 for taxation. (Art. 347, amended, C. B. 2, page 180; T. D. 2987.)

Treasury Decision 2987 (dated March 1, 1920) was made retroactive to January 1, 1918, and all former rulings inconsistent therewith were revoked.

The significant feature of the amended article 347 of Regulations 45, which was issued for the administration of the 1918 law, was the refusal to allow as a deduction by a beneficiary of an estate or trust, any loss, depreciation or depletion sustained by the estate or trust but not deducted from income distributed or distributable to the beneficiary. This regulation by the Treasury Department was not based on any section of the 1918 law which specifically so provided. The

1921 law embodies such a provision, however, which reads as follows:

Law. Section 215. [Items not deductible] . . . . **(b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminshed by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this act for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.**

The Treasury regulation pertaining to this section of the 1921 law gives an example of its effect.

Regulation. Amounts paid to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the passage of time.

No deductions shall be allowed in the case of a life or a terminable interest acquired by gift, bequest, or inheritance, where the estate or trust is entitled to a deduction under the statute but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss but must include in his return the full amount distributed or distributable. . . . . (Art. 295.)

Inasmuch as section 215 (b) gives the sanction of law from January 1, 1921, on, to the position previously taken in administering the 1918 law, the following opinion of the Solicitor of the Bureau of Internal Revenue is in part reproduced.

Ruling. . . . . The present statute specifies class (3) "Income held for future distribution under the terms of the will or trust" and

class (4) "Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals. . . . ." It seems clear that the part of the income which is distributable falls within class (4) and that the part which is accumulated falls within class (3). It is clear that the total amount in question is *income* for which some one should account, and that it would be highly inequitable and unjust to tax the present beneficiary upon income which is not distributable to him and to which he is not beneficially entitled. It is equitable and just, however, that the fiduciary should pay the tax upon income accumulated for the benefit of the remainder-men, thereby deducting the tax from the amount to be distributed to the remainder-men in the future. It is therefore evident that in this case the two classes of income must be treated differently in spite of the general treatment of estates and trusts as a unit by the statute. . . . . (C. B. 2, page 181; O. 1013; Sec. I.)

Regarding the allocation of capital losses to distributable income, it is argued that such losses are not ordinarily allowable deductions to the life tenant, because such deductions belong to the remainderman and, regardless of whether or not there are capital gains to offset such losses, the life tenant is not equitably entitled to take the losses. Denial of such deductions to the life tenant is deemed to be necessary to protect the interests of the remainderman.

RULING. . . . . Trustees may be induced to make such sales in order to register a loss for the benefit of the life tenant. The remainderman is thus prevented from registering the loss at a later date when his remainder becomes vested in possession, and [he] may be compelled to account for an unduly large gain at some time in the future. . . . . (C. B. 2, page 181; O. 1013; Sec. III.)

The reasoning relative to allowance and depreciation to life tenants is stated concisely as follows:

RULING. Items of deduction (according to income tax statute) which are disregarded by the State courts in making distributions, there being no term of the will or trust or rule of law requiring their deduction from distributable income, e. g., depreciation and depletion.

In Law Opinion 456 it was held, under the Revenue Act of 1916 as amended, that the beneficiaries should compute their distributive shares after deduction of depletion. That statute, however, differed from the present one. In Advisory Tax Board recommendation No. 56 a similar ruling was made with reference to depreciation under the Revenue Act of 1918.

These rulings were based upon the literal interpretation of the statute previously discussed and upon the theory that where a will provided for the distribution of income without deduction for depreciation or depletion the beneficiary really received partly income and partly capital. The line of reasoning developed in solving case (III), however, indicates that this result is erroneous. Deductions for depletion and depreciation are deductions designed to restore capital and as such affect the interest of the remainderman and do not affect the distributive share of the life tenant. Probate courts in general disregard depreciation (other than amounts actually expended for repairs) and depletion unless the trust specifically provides that deduction shall be made on that account. The sums received by the beneficiaries in such cases are clearly part of the gross income of the estate or trust and should not be reduced by deductions made to restore capital to which they are not entitled. The answer is the same as the answer to case (III).[58] (C. B. 2, page 181; O. 1013; Sec. IV.)

The Treasury seemed to realize that serious objection would be made to the principles stated in article 347 of Regulations 45.

Ruling. . . . . The principal objection to the answers given to questions (III) and (IV) will be that the construction there adopted may deprive both life tenant and remainderman of the benefit of these deductions for the reason that there will be no income subject to the same treatment in some years from which to deduct them. It is obvious, however, that in many cases a part of the income will be accumulated for future distribution or part of the income will consist of gains from sale of capital assets so that such deduction may be taken. In such cases the equity of the classification of items of gross income and deductions adopted above is emphasized. Such cases will be readily solved by an application of the principles previously stated. The fact that a theoretically correct deduction is not beneficially deducted by anyone is a common occurrence and in no way decisive. The deduction is beneficially allowed if the same interest has a large enough gross income. An individual who has no income loses the benefit of depreciation deductions to which he is entitled. (C. B. 2, page 181; O. 1013; Sec. V.)

Replying to the objection that denial of deduction of capital losses by life tenants is contrary to the express provision of the statute (section 219), which stipulates that the

[58] Section III of this ruling deals with capital losses.

aggregate distributable shares shall not exceed the income of the trust or estate computed as a unit, the Treasury says:

RULING. This applies a literal interpretation of the statute, but reaches a result which should be avoided if possible since it is contrary to the fundamental rights of the parties and to the spirit and purpose of income taxation in general. (C. B. 2, page 181; O. 1013; Sec. III.)

How closely the procedure outlined in article 347 of Regulations 45 is to be considered as indicating the intent of the 1918 law as regards estates, rights and their beneficiaries, remains to be determined, as the courts have not yet passed on the question. The enactment of section 215 (b) of the 1921 law is not necessarily to be deemed to express the intent of the 1918 law. For a discussion of this question, particularly as to the legality of article 347, the reader is referred to pages 1045 to 1046 of *Income Tax Procedure,* 1921.

Tax on capital gains.—The "capital gains" provision of the 1921 law is of importance to estates and trusts because of the amelioration of surtax burdens when considerable gains are realized on sales of investments. This subject is discussed at length in Chapter XVII, and the principal question which needs to be specially considered when applying section 206 to estates and trusts is, as to the starting point for the prescribed two-year period during which investments must be held to obtain the benefits of the "capital gains" provision.

As to securities purchased by the fiduciary, the two-year period obviously runs from the date of purchase. As to securities which form a portion of the corpus of the estate or trust at its inception, the author's opinion is that the two-year period runs from the time the estate comes into the hands of the fiduciary or the trust is created. The time during which a testator or the creator of a trust had held securities afterward sold by a fiduciary cannot be considered as being equivalent to ownership by estate or trust. A decedent's estate or a trust created by an irrevocable deed of trust are separate entities.

Profits or losses on subsequnt sales of securities are based, not on the cost thereof to the decedent in his lifetime or to the maker of the trust, but on their values at the time they came ino the hands of the fiduciary. Similarly, the two-year period under the "capital gains" section starts from the time the securities came into the hands of the fiduciary.

Taxable income under profit-sharing plans.—With the growth of various profit-sharing plans, instituted by employers for the benefit of employees, the law now includes a new provision which defines what is taxable income to the distributees under such a plan.

LAW. Section 219. . . . . **(f) A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.**

REGULATION. Subdivision (f) of section 219 provides that a trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the dividend and interest items specified in subdivisions (a) and (b) of section 216. (Art. 348.)

The question of profit-sharing funds and of the treatment

of income derived therefrom is dealt with fully in the chapter on "Income from Personal Services."[59]

The last sentence of section 219 (f) refers to the allowance as credits of the proportionate share of such exempt dividends and interest referred to in section 216 (a) and (b) as may form a part of the earnings received by, or credited to, the distributee.

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[59] Chapter XIV.

CHAPTER XXXVIII

INSURANCE COMPANIES

The problem of taxing insurance companies in an equitable manner under the income and excess profits tax provisions which govern corporations was considered at length when the 1918 law was being formulated. The Senate Committee proposed and the Senate adopted an entirely new plan for taxing these companies, but the proposal was lost because the House conferees refused to concur.[1]
termining the taxable income of insurance companies (other than mutual insurance companies) which had been proposed and rejected in 1918. A number of sections of the 1921 law
The 1921 law,[2] however, embodies the principle for de-

[1] "A new basis is recommended for the taxation of life insurance companies (Part IV, sections 245, 246, 247). The tax is in form an income tax, but is imposed upon a net income defined with special reference to the peculiar conditions of the business of life insurance. Roughly, it consists of the gross income from interest, dividends and rents, less tax-free interest, investment expenses and taxes and other expenses paid exclusively in connection with real estate owned by the company. In the case of a domestic life insurance company there is also a specific deduction of $2,000. Thus the tax falls upon the true income of the company; that is, its income from investments; and the rate is so fixed that this tax takes the place of the income tax, war excess profits tax, capital stock tax and the tax on the issuance of policies. It will yield considerably more revenue than the taxes which it is designed to replace, and has the great merit of simplicity and certainty. Above all, it avoids the almost insuperable difficulty of defining the invested capital of a life insurance company for purposes of the war excess profits tax." (*Report to Senate*, by Senator Simmons, December 6, 1918, page 9.)

"Your conferees did not think that its scheme would be equitable or satisfactory if the deductions were eliminated, and, after much controversy and much discussion, reflection and investigation—for we did investigate a good deal to see if we could not reach a basis of compromise—finding ourselves unable to come to any satisfactory adjustment with reference to the Senate scheme, the Senate receded." (Senator Simmons, February 11, 1919, *Congressional Record*, page 3777.)

[2] **[Former Procedure]** In view of the radical changes effected by the 1921 law in the determination of taxable income, no attempt will be made in this chapter to give in detail the former procedure with respect to the various items of gross income and deductions. Those who desire to ascertain former procedure are referred to Chapter XXXV of *Income Tax Procedure, 1921*.

are devoted specifically to insurance companies. Sections 243-245 define the taxable income of life insurance companies, and sections 246-247[3] define the taxable income of insurance companies other than life or mutual insurance companies. With the exception of those companies which are entirely exempt under section 231 (10), mutual insurance companies are taxable under sections 232-236 which define the taxable income of ordinary corporations. The last named sections, however, contain certain provisions applicable specifically to mutual insurance companies.

REGULATION. Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. But a corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund if the income and disbursements therefrom are included in the corporation's own return. (Art. 1508.)

To facilitate consideration of the law and regulations pertaining to the different classes of insurance companies, this chapter is divided into the following sections:

1. Life Insurance Companies
2. Insurance Companies Other than Life and Mutual Companies
3. Mutual Insurance Companies
4. Exempt Insurance Companies

Life Insurance Companies

Definition of life insurance company.—

LAW. Section 242. **That when used in this title the term "life insurance company" means an insurance company engaged in the busi-**

[3] Sections 246-247 are effective from January 1, 1922, while sections 243-245 are effective from January 1, 1921. Insurance companies which after 1921 are taxable under sections 246-247, are taxed for 1921 under sections 232-236 which define the taxable income of ordinary corporations.

ness of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds. . . . .

Rates of tax.—

LAW. Section 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;[4]

(2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

REGULATION. For the calendar year 1921 and thereafter, life insurance companies, as defined in section 242, shall pay the tax imposed by section 243, in lieu of the taxes imposed by sections 230 and 1000 and by Title III of the statute. The rate for 1921 is 10 per cent and for subsequent years 12½ per cent, as in the case of other corporations, but the net income upon which the tax is imposed differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 204 (net losses) but not of section 206 (capital net gain). All provisions of the statute and of these regulations not inconsistent with the specific provisions of sections 242 to 245, inclusive, are applicable to the assessment and collection of this tax, and life insurance companies are subject to the same penalties as provided in the case of returns and payment of income tax by other corporations. In determining whether an insurance company is a "life insurance company" as defined in section 242, no reserve shall be regarded as held for the fulfillment of life insurance and annuity contracts unless the company is entitled to a deduction from gross income on account thereof under the provisions of section 245 (a) (2) and article 681. As to foreign companies see section 245(c) and article 687. (Art. 661.)

LIFE INSURANCE COMPANIES NOT SUBJECT TO EXCESS PROFITS TAX.—

REGULATION. . . . . Life insurance companies are not subject to the tax. . . . . (Art. 751.)

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[4] Section 230 imposes a tax of 10 per cent on the net income of corporations for the calendar year 1921, and 12½ per cent for succeeding years.

Gross income defined.—Life insurance companies include in gross income only the amounts received as interest, dividends and rents. No part of premiums received from the assured is now to be included in the return.

LAW. Section 244. **(a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents. . . . .**

Net income defined.—

REGULATION. Net income in the case of life insurance companies is gross income from interest, dividends and rents less the deductions allowed by section 245. Gross income comprises items 25–34, inclusive, of the income page of the annual statement for life companies (edition of 1920) adopted by the National Convention of Insurance Commissioners and items 23-30, inclusive, of the income page of the annual statement for miscellaneous stock companies if any other branches of the insurance business are conducted by the company; except that the rental value of the space occupied by the company in its own building or buildings if included in gross income shall be determined according to the provisions of section 245(b) and article 686. As to "reserve funds required by law," see article 681. (Art. 671.)

Deductions.—Deductions are allowed to take into consideration conditions peculiar to insurance companies, particularly conditions imposed by state laws. The deductions allowed by the 1921 law are materially different from those permitted by the 1918 law. It will be noted among other things that no deduction is provided by the 1921 law for losses on investments, though on the other hand gains realized from sale of securities are not required to be reported as gross income.

EXEMPT INTEREST.—

LAW. Section 245. **(a) (1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title; . . . .**

The interest referred to includes that on United States obligations and those of states, municipalities, etc. For full treatment of this subject, see Chapters XIX and XX.

Reserve fund earning allowance.—

Law. Section 245. (a) . . . . (2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only; . . . .

The definition of "reserve funds required by law" is given below:

Law. Section 244. . . . . (b) The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

The effect of the deductions referred to in subdivisions (1) and (2) of section 245 (a), is to permit a deduction of 4 per cent of the year's average reserves required by law, together with 4 per cent of the mean of certain other reserves not required by law at the discretion of the Commissioner.

Regulation. Under paragraphs (1) and (2) of section 245(a), life insurance companies are entitled to deduct from gross income: (1) Interest which is exempted in the case of other taxpayers by section 213(b) (4) and articles 74-83; and (2) the excess, if any, of the reserve deduction specified in section 245 (a) (2) over the amount of such interest. The reserve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the State insurance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance. In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not

subject to cancellation, it is required that reserves thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. Only reserves peculiar to insurance companies are to be taken into consideration. Reserves "maintained to provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance and unpaid brokerage" (*Maryland Casualty Co. v. United States*, 251 U. S., 342), will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, but the reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7, 8, 9, 10, and 11 of the liability page of the annual statement for life companies,[5] and items 16, 17, 18, 19, and 26 of the liability page of the annual statement for miscellaneous stock companies,[6] if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. (Art. 681.)

CERTAIN DIVIDENDS DEDUCTIBLE.—

LAW. Section 245. **(a) . . . . (3) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217; . . . .**

The deduction is identical with that allowed ordinary corporations under section 234 (a-6).

DIVIDEND RESERVE EARNING ALLOWANCE.—

LAW. Section 245. **(a) . . . . (4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve**

[5] Treasury Bulletin "H," page 27.
[6] Treasury Bulletin "H," page 47.

for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract; . . . .

Regulation. The deduction for deferred dividends under section 245 (a) (4) will be based upon item 37[7] of the liability page of the annual statement for life companies but shall not include any dividend payable during the year immediately following the taxable year. (Art. 682.)

Investment expenses.—

Law. Section 245. **(a) . . . . (5) Investment expenses paid during the taxable year:** *Provided*, **That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year; . . . .**

Regulation. If any general expenses are in part assigned to or included in the investment expenses, the total investment expenses (other than taxes and expenses with respect to real estate) allowable as a deduction shall not exceed one-quarter of 1 per cent of the mean of the book value of the invested assets held at the beginning and end of the taxable year. If there be no allocation of general expenses to investment expenses the deduction may consist of investment expenses actually paid during the taxable year, in which case an itemized schedule of such expenses must be appended to the return. The invested assets are items 1-6, inclusive, item 9, and items 10 and 11 (if interest-bearing assets) of the asset page of the annual statement for life companies, and items 1-4, inclusive, item 7, and items 27-30, inclusive (if interest-bearing assets), of the asset page of the annual statement for miscellaneous stock companies. If the method used by any company in ascertaining the investment expenses where there is any allocation of general expenses shall be changed so that a greater deduction is claimed, the company shall file with its return, information sufficient to enable the commissioner to determine the validity of the claim. The maximum allowance of one-quarter of 1 per cent will not be granted unless it is shown to the satisfaction of the Commissioner that such allowance is justified. (Art. 683.)

Depreciation.—

Law. Section 245. **(a) . . . . (7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable al-**

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[7] "Amounts set apart, apportioned, previously ascertained, calculated, declared, or held awaiting apportionment upon deferred dividend policies. . . . ."

lowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

For the limitation in regard to allowances for depreciation, see section 245 (b) below.

Taxes and expenses with respect to real estate.—

Law. Section 245. **(a) . . . . (6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes; . . . .**

This deduction is subject to the proviso contained in section 245 (b) below.

Regulation. This deduction comprises items 31 and 32 of the disbursement page of the annual statement for life companies and items 34 and 35 of the disbursement page of the annual statement for miscellaneous stock companies, except as noted below, and any sum included in any other item representing taxes imposed upon the individual shareholders' or members' interest in the real estate of the corporation which is paid by the corporation without reimbursement from the individual shareholder or member. In the latter case the amount allowable as a deduction (subject to the provisions of Art. 686) shall be that proportion of the total tax imposed upon the individual shareholders' or members' interest in the corporation which the book value of the real estate owned by the corporation at the end of the taxable year is of the book value of all the corporation's ledger assets, and so much thereof as represents a tax upon real estate occupied in whole or in part by the company must be included in the calculation referred to in article 686. The amount so included shall be that proportion of the total amount allowable as a deduction which the book value of the real estate owned and occupied in whole or in part is of the book value of all the real estate owned. Full details must accompany the return. Any other taxes and expenses (and depreciation) upon any real estate owned and occupied in whole or in part by the company must also be included in the calculation referred

to in article 686. Taxes shall not include assessments against local benefits of a kind tending to increase the value of the property assessed and expenses shall not include any amount paid out for buildings or for permanent improvements and betterments made to increase the value of any property. (Art. 684.)

Limitation on deduction for taxes and depreciation.—

Law. Section 245. . . . . (b) **No deduction shall be made under paragraphs (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied.** . . . .

Interest paid or accrued.—

Law. Section 245. (a) . . . . . (8) **All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;** . . . .

This deduction is identical with that allowed other corporations under section 234 (a-2) with the exception that:

Regulations. . . . . this deduction includes item 18 of the disbursement page of the annual statement of life companies to the extent that interest on dividends held on deposit and surrendered during the taxable year. is included therein. . . . . (Art. 685.)

No deduction shall be made for any taxes, expenses, or depreciation on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall not be less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and other expenses) at the rate of 4 per cent per annum of the book value at the end of the taxable year of the real estate so owned and occupied. For example, if the book value of a parcel of real estate owned and occupied in whole or in part by the company is $1,000,000, the

rents received from other tenants $30,000, taxes and expenses $40,000, and depreciation $20,000, the company would have to include in its gross income a sum not less than $70,000 ($40,000 taxes and expenses, plus $20,000 depreciation, minus $30,000 rents from tenants, plus 4 per cent of $1,000,000) as the rental value of the space occupied by it in order to avail itself of the deductions of $40,000 and $20,000. In any case the rents received from other tenants must be included in gross income. (Art. 686.)

Specific credit.—

Law. Section 245. **(a) . . . . (9) In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. . . . .**

This provision is identical with the corresponding allowance made for income tax purposes to other corporations under section 236 (b).

Taxable income of foreign company.—The net income of a foreign company subject to United States income tax is ascertained as follows:

Law. Section 245. . . . . **(c) In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.**

Regulation. Foreign life insurance companies holding reserve funds upon business transacted within the United States are taxed under section 243 upon their net income from sources within the United States. All business transacted by a United States branch or agency of a foreign insurance company, for which a reserve fund is required by the laws of any State or Territory of the United States or of the District of Columbia, will be regarded as business transacted within the United States. A foreign life insurance company not doing an insurance business within the United States and holding no reserve funds upon business transacted within the United States, but which derives income from sources within the United States as de-

fined in section 217[8] . . . . is subject to the tax imposed by section 230 upon income derived from sources within the United States. . . . . As to taxation of life insurance companies between United States and Porto Rico and Philippine Islands, see article 1133. (Art. 687.)

Insurance Companies Other than Life and Mutual Companies

Sections 246 and 247 of the 1921 law, which are applicable to this class of insurance companies are effective only from January 1, 1922. Therefore, for the year 1921 these companies are taxed under sections 232 to 236 which, in their application to insurance companies, are considered later in this chapter.[9] Insurance companies in this class are also subject to excess profits tax and to capital stock tax for the year 1921.

Following are the law provisions effective from January 1, 1922:

Rates of tax.—

LAW. Section 246. **(a) That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:**

(1) In the case of such a domestic insurance company the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230. . . . .

The rate provided by section 230 for the year 1922 and subsequent years is 12½ per cent.

REGULATION. For the calendar year 1921 all insurance companies (other than life) are subject to taxes imposed by sections 230 (corporation income tax) and 1,000 (capital stock tax) and Title III (war profits and excess profits tax). For the calendar year 1922 and thereafter, however, in lieu of such taxes, insurance com-

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[8] See pages 1272, 1278.

[9] See pages 1394, 1401.

panies, except life and mutual companies, are subject to the tax imposed by section 246. Mutual insurance companies (other than life) remain subject to the taxes imposed by sections 230 and 1,000. In articles 691-693 the term "insurance companies" means only those companies subject to the tax imposed by section 246. The rate of the tax imposed by section 246 is the same as the rate imposed by section 230 (12½ per cent), but the net income upon which the tax is imposed, as defined in sections 246 and 247, differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 204 (net losses) but not of section 206 (capital net gain). All provisions of the statute and of these regulations not inconsistent with the specific provisions of sections 246 and 247 are applicable to the assessment and collection of this tax, and insurance companies are subject to the same penalties as provided in the case of returns and payment of income tax by other corporations. Since section 246 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the first returns under section 246 will be for the taxable year ending December 31, 1922, and will be made on or before March 15, 1923. (Art. 691.)

Gross income defined.—

LAW. Section 246. . . . . **(b) In the case of an insurance company subject to the tax imposed by this section—**

(1) The term "gross income" means the combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners; . . . .

INVESTMENT INCOME.—

LAW. Section 246. . . . . **(b) . . . . (3) The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends and rents, computed as follows:**

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year; . . . .

UNDERWRITING INCOME.—

LAW. Section 246 . . . . **(b) . . . . (4) The term "underwriting income" means the premiums earned on insurance contracts**

during the taxable year less losses incurred and expenses incurred. . . .

PREMIUMS EARNED.—

LAW. Section 246. . . . . (b) . . . . (5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year; . . . .

Net income defined.—

LAW. Section 246. . . . . (b) . . . . (2) The term "net income" means the gross income as defined in paragraph (1) of this subdivision less the deductions allowed by section 247; . . . .

REGULATION. Net income is gross income as defined in section 246 less the deductions allowed in section 247. Gross income is the combined gross amount earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners. Gross income does not include gain derived from sale of disposition of capital assets, nor are losses sustained from such sale or disposition allowable deductions. It does not include increase in liabilities during the year on account of reinsurance treaties; remittances from home office of a foreign insurance company to United States branch; borrowed money; gross profit on maturity of capital assets; gross increase due to adjustments in book value of capital assets and premium on capital stock sold. The underwriting and investment exhibit is presumed clearly to reflect the true net income of the company, and in so far as it is not inconsistent with the provisions of the statute will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the statute. By reason of the definition of investment income, profit or loss on investment items is ignored, as well as those miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared, home office remittances and receipts, and special deposits. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency bal-

ances and bills receivable as have been charged off the books of the company as bad debts, or having been previously charged off are recovered during the taxable year. (Art. 692.)

Deductions.[10]—The statutory deductions allowed insurance companies other than life and mutual companies after 1921,[11] are as follows:

Ordinary and necessary expenses.—

Law. Section 247. **(a) . . . . (1) All ordinary and necessary expenses incurred, as provided in paragraph (1) of subdivision (a) of section 234; . . . .**

The deduction is the same as that allowed to other corporations.

Regulation. For the calendar year 1921 insurance companies (other than life insurance companies) are entitled to the same deductions from gross income as other corporations, and also to the deduction of the net addition required by law to be made within the taxable year to reserve funds and of the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, such insurance companies, except mutual companies, are entitled only to the deductions allowed by section 247. . . . . Mutual insurance companies (other than life) are not entitled to the deductions allowed by section 247, but are entitled to the deductions allowed by section 234. . . . . "Paid" includes "accrued" or "incurred" (construed according to the method of accounting upon the basis of which the net income is computed) during the taxable year, but does not include any estimate for losses incurred but not reported during the taxable year. . . . . (Art. 568.)

"Expenses incurred" defined.—

Law. Section 246. . . . . **(b) . . . . (7) The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:**

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall

[10] Law. Section 247. "(c) Nothing in this section or in section 246 shall be construed to permit the same item to be twice deducted."

[11] For law and regulations applicable to these companies during 1921, see pages 1380 and 1395.

be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by section 247.

INTEREST PAID OR ACCRUED.—

LAW. Section 247. (a) . . . . **(2) All interest as provided in paragraph (2) of subdivision (a) of section 234; . . . ..**

This section allows the deduction of all interest paid or accrued, except that arising from the purchase or carrying of tax-exempt securities (other than original subscriptions to United States obligations issued after September 24th, 1917).

For full treatment see Chapter XXVII.

TAXES PAID OR ACCRUED.—

LAW. Section 247. **(a) . . . . (3) Taxes as provided in paragraph (3) of subdivision (a) of section 234; . . . .**

REGULATION. . . . . Among the items which may not be deducted are income and profits taxes, paid or accrued, imposed by the United States and so much of the income and profits taxes imposed by any foreign country or possession of the United States as is allowed as a credit under section 238; taxes assessed against local benefits; donations; decrease during the year due to adjustments in book value of capital assets; decrease in liabilities during the year on account of reinsurance treaties; dividends paid to stockholders; remittances to home office of a foreign insurance company by United States branch; and borrowed money repaid. (Art. 693.)

CREDIT FOR TAXES.—

REGULATION. . . . . A domestic insurance company is also entitled to the credit for income, war profits, and excess profits taxes paid during the taxable year to any foreign country or to any possession of the United States which is allowed other domestic corporations by section 238.[12] . . . . (Art. 693.)

For full treatment of the subject of taxes, see Chapter XXVIII.

LOSSES.—

LAW. Section 247. **(a) . . . . (4) Losses incurred; . . . .**

"LOSSES INCURRED" DEFINED.—

LAW. Section 246. . . . . **(b) . . . . (6) The term "losses**

[12] See page 947.

incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the results so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year; . . . .

It will be noted that the term "losses incurred" is so narrowly defined that it cannot include losses sustained on investments. On the other hand, as is also true in the case of life insurance companies,[13] the gains from investments, as distinguished from investment income[14] therefrom ("interest dividends and rents") are not required to be included in taxable gross income.

BAD DEBTS.—

LAW. Section 247. **(a) . . . . (5) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year; . . . .**

The subject of bad debts is treated at length in Chapter XXX.

CERTAIN DIVIDENDS DEDUCTIBLE.—

LAW. Section 247. **(a) . . . . (6) The amount received as dividends from corporations as provided in paragraph (6) of subdivision (a) of section 234; . . . .**

The dividends in question are those received from domestic corporations and from foreign corporations of whose gross income for the preceding three-year period more than 50 per cent was derived from sources within the United States. This subject is dealt with in Chapter XXII.

EXEMPT INTEREST.—

LAW. Section 247. **(a) . . . . (7) The amount of interest earned during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title, and**

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[13] See page 1380.
[14] Section 246 (b-3).

the amount of interest allowed as a credit under subdivision (a) of section 236; . . . .

The interest which may be deducted is that from obligations of the United States or its possessions, a state, territory or any political subdivision thereof, or the District of Columbia, also from Farm Loan bonds and bonds issued by the War Finance Corporation. See Chapters XIX and XX.

DEPRECIATION.—

LAW. Section 247. **(a) . . . . (8) A reasonable allowance, for the exhaustion, wear and tear of property, as provided in paragraph (7) of subdivision (a) of section 234; . . . .**

For a full treatment of depreciation, see Chapter XXXI.

SPECIFIC CREDIT.—

LAW. Section 247. **(a) . . . . (9) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 246 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. . . . .**

Taxable income of foreign company.—The law contains in the case of "insurance companies other than life and mutual insurance companies" no specific direction as to how the gross or net income of foreign companies is to be determined. It is simply stated in section 246 (a-2)[15] that "its net income from sources within the United States" is to be subjected to the same rate of tax as is imposed upon the income of ordinary corporations. It is to be assumed that from the gross income from sources within the United States [subject to the definitions of such income contained in section 246 (b)[16]] are to be subtracted the deductions allowed by section 247.[17] These deductions are subject to the following limitation:

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[15] See page 1387.
[16] See pages 1388, 1389.
[17] See page 1390.

LAW. Section 247. . . . . **(b) In the case of a foreign corporation the deduction allowed in this section shall be allowed to the extent provided in subdivision (b) of section 234. . . . .**

Section 234 (b)[18] limits the deductions of foreign corporations to those "connected with income from sources within the United States."

Mutual Insurance Companies

Mutual insurance companies other than those which are exempt[19] are taxed on a basis similar to that of other corporations, with certain exceptions noted below. For the year 1921 this basis also applied to insurance companies "other than life and mutual insurance companies" which after December 31, 1921, are taxed under special sections of the 1921 law.[20] Insurance companies taxed on this basis are subject to excess profits tax for 1921 and to capital stock tax.

Gross income.—Section 233, in defining gross income for corporations generally, makes applicable thereto the provisions of section 213 (individuals) and section 217 (non-resident alien individuals). The only specific reference to insurance companies is "that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance."

LAW. Section 233. **(a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 and 217, except that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. . . . .**

Section 230 imposes a corporation income tax of 10 per cent for 1921, and 12½ per cent for each year thereafter.

REGULATION. The gross income of mutual insurance companies (other than life) consists of their total revenue from the operation

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[18] See page 1292.
[19] See page 1401.
[20] Sections 246-247; see pages 1387-1389.

of the business and of their income from all other sources within the taxable year, except as otherwise provided by the statute. Gross income includes net premiums (that is, gross premiums less returned premiums on policies cancelled and premiums on policies not taken), investment income, profits from the sale of assets, and all gains, profits, and income reported to the State insurance departments, except income specifically exempt from tax. Premiums received by mutual marine insurance companies which are paid out for reinsurance should be eliminated from gross income and the payments for reinsurance from disbursements. Deposit premiums on perpetual risks received and returned by mutual fire insurance companies should be treated in the same manner, as no reserve will be recognized covering liability for such deposits. The earnings on such deposits, including such portion, if any, of the deposits as are not returned to the policyholders upon cancellation of the policies, must be included in the gross income. A net decrease in reserve funds required by law within the taxable year must be included in the gross income to the extent that it is released to the general uses of the company and increases its free assets. Any net decrease in reserves shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established. . . . . (Art. 549.)

SHIPOWNERS' MUTUAL PROTECTION AND INDEMNITY ASSOCIATIONS.—If such associations are not organized for profit and no part of the earnings inures to the benefit of any stockholder, they are subject to tax only on net income from interest, dividends and rents.

REGULATION. The following additional exclusions from gross income . . . . are allowed by the Revenue Act of 1921.

. . . . (4) Receipts of shipowners' mutual protection and indemnity associations not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or member. Such associations, however, shall be subject as other taxpayers to the tax upon their net income from interest, dividends, and rents. In other words, they are subject to the taxes imposed by section 230, but only upon net income from interest, dividends, and rents; . . . . (Art. 89.)

Deductions allowed.—The deductions allowed mutual companies are those provided in section 234[21] (not those detailed in

[21] See Chapters on Expenses (XXVI), Interest (XXVII), Taxes (XXVIII), Losses (XXIX), Bad Debts (XXX), and Depreciation (XXXI).

section 247), with certain additional deductions to meet the special circumstances obtaining in the case of insurance companies.

ADDITIONS TO RESERVE FUNDS.—

LAW. Section 234. **(a) . . . . (10) In the case of insurance companies (other than life insurance companies), in addition to the above (unless otherwise allowed): (A) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (B) the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, this subdivision shall apply only to mutual insurance companies other than life insurance companies; . . . .**

REGULATION. This article applies to all insurance companies (except life) for the calendar year 1921; thereafter it applies only to mutual companies. Insurance companies may deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guaranty or reserve funds. Reserve funds "required by law" include not only reserves required by express statutory provisions but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. Casualty companies may deduct losses incurred within the taxable year; but unless the net addition to the unpaid loss reserve required by law exceeds such losses incurred, no deduction for the net addition to the unpaid loss reserve may be taken. In any event only the excess of such net addition over such losses may be deducted. Mutual hail and mutual cyclone insurance companies are entitled to deduct from gross income the net addition which they are required to make to the "guaranty surplus" fund or similar fund. . . . . (Art. 569.)

RULINGS. The decision of the United States Supreme Court in Maryland Casualty Company v. United States[22] does not authorize

[22] 251 U. S. 342.

any insurance company to deviate from the present method of computing the "net addition to reserve funds" deductible from gross income. The amount deductible is the excess of the total reserve funds as required by law at the end of the taxable year over the total of such reserve funds at the beginning of the year regardless of the fact that during the year the reserve funds are increased on account of new business, and decreases in such funds are inevitable when policies mature, lapse, or are surrendered. (C. B. 2, page 216; O. D. 427.)

Reserve funds "required by law" include not only reserves required by express statutory provisions, but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage.

Where there is a net decrease in the reserve funds required to be maintained by an insurance company, so much of the decrease as is released to the general uses of the company and increases its free assets is income to the company.

Any net decrease in reserve shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established. (C. B. 2, page 216; L. O. 1032.)

It would seem that outstanding liabilities for expenses such as salaries should be set up and deducted as such instead of being included in the reserve "required by law."

RULING. A reserve for the expense of investigating loss claims of an insurance company is not a "reserve" within the meaning of paragraph G (b) of the Act of October 3, 1913, and therefore any net addition thereto may not be deducted in determining net income subject to tax. (C. B. 3, page 276; Sol. Op. 76.)

As stated above, accrued expenses should be deducted as such and not as a "reserve." The deduction, however, is permitted only when taxpayers keep their books on the accrual system. It would appear from the foregoing ruling that the deduction was denied because it was not properly accrued on the books at the time.

In passing on the question of "whether the reserve set up by a fire insurance company against unpaid losses is a reserve within the meaning of the provision . . . . permitting a

deduction from gross income in the case of insurance companies, of the 'net addition required by law to be made within the taxable year to reserve funds,'" the Solicitor of Internal Revenue stated[23] that:

RULING. The insurance commissioners of the several States require fire insurance companies to return each year as an item of their liabilities the net amount of unpaid losses whether actually adjusted or in process of adjustment or resisted, and it is contended on behalf of such insurance companies that, under the decision of the Supreme Court of the United States in the case of the *Maryland Casualty Company v. United States*, 251 U. S. 342 (T. D. 3013), the amount of this item constitutes a "reserve" within the meaning of the provision of the Revenue Act of 1918 above cited.[24]

The Solicitor further stated, however, that:

It has been repeatedly stated on behalf of the fire insurance companies, and never denied, that their books are kept upon an accrued and incurred basis. It is clear, therefore, that under the law they are entitled to deduct the several items included in unpaid losses as "losses" and to allow them also to include these items in reserves the net additions to which may be deducted from gross income in determining the taxable income of such companies, would be in effect to permit them a double deduction, a result which can not be presumed to have been intended by Congress, and which could only be reached under the compulsion of an express provision of the statute.

It is hardly conceivable that insurance companies would intentionally claim a double deduction for losses. It would appear from the Solicitor's opinion that, while he holds that unpaid losses are not deductible as "reserves," they are deductible as "losses" if a company's books are kept on an accrual basis.

Special deductions in the case of combined life, health and accident policies.—

LAW. Section 234. **(a) . . . . (11) In the case of corporations (except those taxed under section 243)[25] issuing policies covering**

[23] C. B. 4, page 297; L. O. 1056.

[24] Section 234 (a-10-a), re-enacted without substantial change in 1921 law.

[25] Life insurance companies.

life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only. This subdivision shall not be in effect after December 31, 1921; . . . .

REGULATION. Corporations which issue combination policies of life, health, and accident insurance on the weekly premium payment plan, continuing for life and not subject to cancellation, may deduct from gross income only such portion of the net addition not required by law made within the taxable year to reserve funds as is needed for the protection of the holders of such combination policies. In general the net addition to any fund especially maintained for the protection of such policyholders may be deducted. The determination by the company of the need for such addition is subject to review by the commissioner, and the return of income should be accompanied by a full explanation of the basis upon which such fund and the additions to it are determined. This article does not apply to life insurance companies taxed under section 243 nor to any taxable period after December 31, 1921. (Art. 570.)

After the enactment of the 1918 law, some insurance companies writing policies described in section 234 (a-11) contended that, since no reserve for the purpose was recognized prior to the 1918 law, the entire reserve might now be deducted, including the portion set up prior to 1918. The Solicitor of Internal Revenue, replying to this contention, cited a statement made in a Federal Court case[26] that, "there is no safer or better settled canon of interpretation than that when language is clear and unambiguous it must be held to mean what it plainly expresses, and no room is left for construction," and pointed out that the law specifically provided that the deduction to be allowed is only for "the net addition . . . . made within the taxable year." He further pointed out that the portion of the addition to be allowed as a deduction is by law within the discretion of the Commissioner and that the latter had promulgated a regulation (article 570, Regulations 45) the effect of which was that the maximum deduction is

[26] *Swarts v. Siegel*, 117 Fed. 13, 18.

the net addition (not required by law) within the taxable year to reserve funds.

PREMIUM REPAYMENTS BY MUTUAL MARINE INSURANCE COMPANIES.—

LAW. Section 234. (a) . . . . **(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10) inclusive, and paragraph (14), unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof; . . . .**

REGULATION. Mutual marine insurance companies should include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. . . . . They may deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them, together with the interest actually paid upon such amounts between the date of ascertainment and the date of payment thereof. The remainder of the premiums accordingly form part of the net income of the company, except to the extent that they are subject to the deductions allowed such insurance companies and other corporations. (Art. 571.)

PREMIUM DEPOSITS RETURNED OR RETAINED.—

LAW. Section 234. (a) . . . . **(13) In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves; . . . .**

REGULATION. Mutual insurance companies (other than mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses, and reinsurance reserves. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses, and reinsurance reserves, it will be presumed that losses and expenses have been paid out of earnings and profits other than premiums to the extent of such earnings and profits. If, however, any portion of such amount is applied during the taxable year to the pay-

ment of losses, expenses, or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible; and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses, or reinsurance reserves, then such payment can not be separately deducted. An amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted. A company which invests part of the premium deposits so retained by it in interest-bearing securities may nevertheless deduct such part, but not the interest received on such securities. A mutual fire insurance company which has a guaranty capital is taxed like other mutual fire insurance companies. A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan. (Art. 572.)

RULING. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses and reinsurance reserves, it is to be presumed that losses and expenses have been paid out of earnings and profits, other than premium, to the extent of such earnings and profits. Office Decision 403 (Bulletin 7-20) overruled. (C. B. 3, page 279; L. O. 1050.)

Insurance Companies Which Are Exempt

Mutual insurance companies which conform to certain specified requirements are exempt from taxation.

Fraternal beneficiary societies.[27]—

LAW. Section 231. . . . . (3) **Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents; . . . .**

Mutual insurance companies and like organizations.—

LAW. Section 231. . . . . (10) **Farmers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely**

[27] For rulings regarding fraternal beneficiary societies, see Chapter II.

of assessments, dues, and fees collected from members for the sole purpose of meeting expenses; . . . .

Regulation. It is necessary to exemption that the income of the company be derived solely from assessments, dues, and fees collected from members. If income is received from other sources, such as cash premiums or premium deposits, the corporation is not exempt, even though its additional income is tax exempt. Income, however, from sources other than those specified does not prevent exemption where its receipt is a mere incident of the business of the company. Thus the receipt of interest upon a working bank balance, or of the proceeds of the sale of badges, office supplies or equipment, will not defeat the exemption. The same is true of the receipt of interest upon Liberty bonds, where they were purchased as a patriotic duty and were afterwards sold. Where, however, such bonds are bought as a permanent investment, the receipt of the interest destroys the exemption. The receipt of what is in substance an entrance fee, charged by a mutual fire insurance company as a condition of membership, does not render the company taxable, although this fee is called a premium. A farmers' mutual fire and lightning insurance company does not become taxable because it makes advance assessments for the sole purpose of meeting future losses and expenses, where any balance of such assessments remaining at the end of the year is retained to meet losses and expenses in the ensuing year. But the issuance of policies for stipulated cash premiums prevents exemption. A local exchange or association to insure the owners of automobiles against fire, theft, collision, public liability, and property damage is exempt, since it performs functions of the same character as a mutual fire insurance company, and is a like organization within the meaning of the statute. A local reservoir and ditch company may likewise be exempt from tax. An organization doing business on the "interindemnity" or "reciprocal insurance" plan through an attorney in fact subject to direction of an advisory board of policyholders, which requires advance deposits to cover the cost of the insurance and maintains investments or deposits from which substantial income is derived, is not exempt. The exemption does not include a telephone clearing association, whose business is to apportion toll rates between independent telephone companies handling the same calls and whose income consists of compensation paid by such companies and receipts from the sale of form blanks. The phrase "of a purely local character" qualifies all the organizations enumerated in subdivision (10) of section 231. An organization of a "purely local character" is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. The word "purely" intensifies and limits "local," and indicates a clear intention on the part of Congress

to exempt from taxation only such organizations as are entirely and unqualifiedly "local" in their operations. (Art. 521.)

It has been held that a farmers' mutual fire and lightning insurance company does not lose its exempt status by reason of having funds on hand at the end of its taxable year due to additional assessments to meet expenses for the ensuing year. The following quotation from the opinion of the Solicitor of Internal Revenue is of interest:

RULING. Assessments are made by mutual fire insurance companies either after losses occur or in anticipation of such losses. It is thought that the majority of such companies at the present time make assessments to meet estimated future losses, the assessments being made quarterly, half-yearly, or yearly, as the case may be. The advantages of making assessments in this manner are obvious, avoiding as they do operating expenses incidental to the making of a large number of assessments to meet particular losses as they occur. Where assessments are made in this manner, the resulting fund is held by the company, and any unexpended balance at the end of the year is retained and applied to expenses and losses for the ensuing year, the assessment or assessments for that year being reduced accordingly. The unconsumed portion of the assessments is not returned to the policyholders as in the case of premium deposits. . . . .

The policyholder is in precisely the same position as where the assessment is made subsequent to the loss, except that he is called upon to make his payment at an earlier time and is spared the annoyance of a large number of payments to meet the individual losses as they occur. In either case the amount he eventually pays should be the same. (C. B. 4, page 270; Sol. Op. 99.)

STATE CREATED MUTUAL LIABILITY INSURANCE COMPANY NOT EXEMPT.—The exemption of a mutual liability insurance company created by the act of a state depends upon the nature of the controlling management.

RULING. The funds contemplated by article 84 of Regulations 45[28] are only those managed and controlled directly by the State through State officers, that is to say those funds the management and control of which constitute an activity of the State. A mutual liability insurance company created by an act of the State legislature to provide insurance for employers to cover their liability under the State employers' liability act and workmen's compensation law, which is

[28] See Art. 87 of the 1921 regulations which is identical.

not so managed and controlled, is not exempt from taxation under section 213 (b) 7, or under any other provision of the Revenue Act of 1918. (B. 43-21-1883; O. D. 1074.)

Reciprocal indemnity exchange not necessarily exempt.—A number of manufacturers incorporated as a reciprocal indemnity exchange to insure their businesses against fire loss, each subscriber depositing a fixed amount to meet losses, and at the end of the period any unexpended balance being returned to the depositors.

This exchange was originally held to be exempt.[29] The earlier decision was, however, overruled by the following:

Ruling. A number of manufacturers incorporated as a reciprocal indemnity exchange to insure their business against fire loss on the reciprocal and inter-insurance plan through an attorney in fact having the power to issue policies, collect premiums and adjust losses.

While the subscriber's contract provides that there shall be no joint funds, the rules of the association show that the provision is not carried out in letter or spirit. The advance payments are not all made directly to the attorney but direct to the exchange and are charged in the nature of advance premium deposits.

Provision is made in the rules of the association for cancellation of the policies on a short rate basis. In view of the above facts it is held that the association does not come within the exemption provided in paragraph 10, section 231 of the Revenue Act of 1918, and will therefore be required to file returns of annual net income. (C. B. 4, page 269; O. D. 866.)

Automobile owners insurance exchange held to be exempt.—An insurance company incorporated for the purpose of permitting automobile owners to exchange contracts of insurance and indemnity without becoming jointly liable as subscribers on any risks, its only source of income being from assessments collected from members for the sole purpose of meeting expenses, was held to be exempt.[30]

Rulings holding certain corporations not exempt.—The following corporations have been held by the Treasury not to be exempt under section 231 (3) and (10): an associa-

[29] C. B. 2, page 210; O. D. 538.
[30] C. B. 1, page 207; O. D. 312.

tion operated under the lodge system, its charter providing for the union of its members into a grand fraternal beneficiary educational and patriotic society which assessed its members to provide for sick and death benefits, but derived income from subscriptions to a paper which it published as well as from job printing and other sources;[31] a mutual liability insurance company which derived its income from premiums and assessments of its members which were used to defray operating expenses and indemnify policyholders against payments under a workmen's compensation law;[32] a travelers' association providing for fixed death benefits to the beneficiaries of its members;[33] a mutual irrigating ditch company which derived income from rents for the use of its surplus water;[34] a casualty insurance association organized for the purpose of insuring its members throughout a state which issued policies for stipulated cash premiums.[35]

An association qualified as a "like organization under section 231 (10) but was held not to be of a purely local character" when its business activities were not confined to a particular community, place or district, but covered an entire state.[36]

Returns of Insurance Companies

Regulation. Insurance companies transacting business in the United States or deriving an income from sources therein are required to file returns of income. The return shall be on Form 1120, except that life insurance companies shall make return on Form 1120 L. As an aid in auditing the returns, wherever possible a copy of the report to the State insurance department should be submitted with the return. Otherwise a copy of schedule D, parts 1, 3 and 4, of the report should be attached to the return, showing the Federal, State, and municipal obligations from which the interest omitted from gross income was derived, and a copy of the complete report should be furnished as soon as ready for filing. (Art. 623.)

[31] C. B. 2, page 207; O. D. 508.
[32] C. B. 1, page 206; O. D. 252.
[33] C. B. 1, page 206; O. D. 63.
[34] C. B. 1, page 207; O. D. 318.
[35] C. B. 1, page 203; O. 790.
[36] C. B. 1, page 205; O. 792.

Net Losses

The provision of the 1921 law[37] whereby taxpayers may deduct net losses resulting from the operation of their regular trade or business from the net income of the succeeding taxable year, and from the second succeeding taxable year, if necessary, extends to all insurance companies.

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[37] Section 204; see pages 1022-1029.

CHAPTER XXXIX

FARMERS

The lowering of the specific exemption to $1,000 and $2,000 in 1917 had the effect of bringing many thousands of farmers within the class of income tax payers. There are many difficulties involved in the assessment of tax upon the true net income of a farmer, the accounting difficulty being very serious. It is now generally recognized, however, that accurate accounting of the income and expenses incident to the business of farming is practicable and is very beneficial to the farmer. The attempt by the Commissioner of Internal Revenue to secure returns which reflect actual operating results should have unanimous support.

It has been charged in the past that law makers legislate in favor of the farmer whenever possible. It is questionable whether the farmer ever demanded special favors. It may rather be assumed that all he asked was a square deal, that is, the right to insist that no undue burden be placed upon him. It has not been shown that farmers as a class have knowingly evaded income tax requirements. Inability to understand the laws and difficulty in determining actual net income have probably deterred many from making returns. Under saner laws and intelligent administration it may be expected that many returns and substantial taxes will be received.

To the extent that a farmer is not required to return as income that part of his crops which is consumed as food by himself and his family he receives an allowance for living expenses. This is an allowance which is not permitted to any other class of taxpayers. As soon as possible the allowance should be withdrawn.

In Great Britain a method was devised under which a farmer's taxable income was assumed to have a definite rela-

tion to the rental value of the farm. Such a method would hardly meet with favor in the United States; but if a farmer is not willing to keep books and ascertain, even roughly, his net income some plan should be devised whereby to impose a reasonable tax in all cases in which a tax obviously is due.

The introduction of the inventory system will do more than anything else to prove to the farmer that there may be an increase in net worth even though his bank balance has not increased.

Gross income.—Farmers of course are taxable on any gain derived from sale of all or part of their farm property. In such cases the rules applicable to gains arising from sales are applicable.[1]

During 1919 and 1920 many thousands of farms changed hands and it is said that enormous profits were realized by the sellers. The return of such profits should have yielded a large tax.

Under the 1921 law the gain arising from the sale of farms, title to which has not changed within two years, immediately prior to the sale, will be subject to the maximum rate of 12½ per cent imposed upon capital gains. Such crops as form part of the sale should not be included among capital assets.

REGULATIONS. A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the de-

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[1] See page 535.

preciation theretofore sustained and allowable as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory to determine profits is used) his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. . . .

Sale of machinery equipment, etc.—

In every case of the sale of machinery, farm equipment, or other capital assets (which are not to be included in an inventory if one is used to determine profits) any excess over the cost thereof less the amount of depreciation theretofore sustained and allowable as a deduction in computing net income, shall be included as gross income.

Exchange of produce for merchandise.—

Where farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income.

Rents.—

Rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or a money equivalent.

Proceeds of insurance.—

Proceeds of insurance, such as hail and fire insurance, on growing crops should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed.

Computing income on crop basis.—

If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing,

the income therefrom may be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized.

Definition of "farm."—

As herein used the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms, also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated farmers.

"Gentlemen" farmers.—

A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer. . . . . (Art. 38.)

Regulations. . . . . If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure. . . . . (Art. 145.)

. . . . If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. . . . . (Art. 110.)

It may be inferred from the foregoing that if a person makes a profit out of operating a farm he is a farmer.

The Treasury's position is as follows:

Ruling. It is held that where a farm is operated on a basis other than the recognized principles of commercial farming, such a farm is not to be classed as a commercial enterprise, inasmuch as it does not form a part of the owner's business or trade, and until it is placed upon a profit-paying basis the gross receipts are not to be reported under "gross income" and the expenses are not to be claimed as a deduction. (Extract from letter to a taxpayer, February 9, 1920.)

The regulations are quite right in refusing to allow losses unless it can be shown that a farm is operated as if it were a transaction undertaken for profit.

If a taxpayer conducts the farm or estate chiefly for recreation or pleasure, and not as he would conduct a business for profit, the loss, if any, is apparent only. The deficit is a family, personal or living expense.

But if a taxpayer in good faith embarks in the farming business and loses money during one or more years the loss is an allowable deduction under the law, to the same extent that losses are allowable in other businesses.

The question to be decided is whether the farm is being operated as a business or for recreation or pleasure. It is necessary to judge the facts of each case before the point can be settled. In a case that has been given considerable prominence in the press,[2] the court charged the jury as follows:

DECISION. That, if the plaintiff was a person cultivating and operating a farm for recreation or pleasure, other than on the recognized principles of commercial farming, then he was not a farmer.

That if the jury find that the plaintiff was the owner of a body of land devoted to agriculture, either to the raising of crops or pasture, for the purpose of selling the products as a business, then they are entitled to find a verdict in favor of plaintiff on this issue.

Business is that which occupies the time, attention and labor of men for the purpose of a livelihood or profit. It is that which is his personal concern, interest or regular occupation.

In deciding the foregoing case the jury found (and the court sustained the finding) that the following constituted a "business" farm:

The Continental Village farm was located in Putnam County, and consisted of 1,300 acres, 900 of woodland and 400 cultivated. The place was equipped with cow barns and there were 40 cows there, and there was evidence of it being a cattle farm. There were no profits upon the farm, although there was reasonable probability of believing that some day there would be.

It was also decided that another farm was maintained for recreation or pleasure:

[2] *Stuyvesant Fish v. Roscoe Irwin*, U. S. Dist. Ct., No. Dist. of N. Y., July 29, 1921.

The Glenclyffe farm consisted of 480 acres, and only 70 were cultivated and the testimony was that there never was a profit or reasonable expectancy of a profit, that the expenses were far in excess of what legitimately would be a farm venture, that the raising of crops was more of a hobby than a business.

Ruling. When an executor operated a decedent's farm prior to disposition thereof, the costs of operation were deductible even though the decedent was not entitled to such deduction.

It could not be held that the executor operated the farm as a hobby or for pleasure. (C. B. 3, page 145; A. R. R. 249.)

Farmers' associations.—

Regulation. (*a*) Cooperative associations, acting as sales agents for farmers, fruit growers, dairymen, etc., and turning back to them the proceeds of the sales, less the necessary selling expenses, on the basis of the produce furnished by them, are exempt from income tax. Thus cooperative dairy companies, which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among their members upon the basis of the quantity of milk or of butter fat in the milk furnished by such members, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, or if the association deducts more than necessary selling expenses, it does not meet the requirements of the statute and is not exempt. The maintenance of a reasonable reserve for depreciation or possible losses or a reserve required by State statute will not necessarily destroy the exemption. A corporation organized to act as a sales agent for farmers and having a capital stock on which it pays a fixed dividend amounting to the legal rate of interest, all of the capital stock being owned by such farmers, will not for that reason be denied exemption.

(*b*) Cooperative associations organized and operated as purchasing agents for farmers, fruitgrowers, dairymen, etc., for the purpose of buying supplies and equipment for the use of members and turning over such supplies and equipment to members at actual cost, plus necessary expenses, are also exempt. In order to be exempt under either (*a*) or (*b*) an association must establish that it has no net income for its own account. An association acting both as a sales and a purchasing agent is exempt if as to each of its functions it meets the requirements of the statute. (Art. 522.)

Expenses deductible.—

Regulation. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming.

Tools.—

The cost of ordinary tools, of short life or small cost, such as hand tools, including shovels, rakes, etc., may be included.

Feeding and raising live stock.—

The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. . . .

Farm machinery and buildings.—

The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense.

Development expenses.—

Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital.

Cost of draft or work animals or live stock.—

Amounts expended in purchasing work, breeding or dairy animals are regarded as investments of capital. . . .

Cost of automobile not deductible.—

The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital.

Upkeep of automobile may be deductible.—

The cost of gasoline, repairs and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. . . . (Art. 110.)

Depreciation.—

Regulation. A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property. A reasonable allowance for depreciation may also be claimed on live stock

acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with article 38. Such depreciation should be based on the cost and the estimated life of the live stock. If such live stock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. . . . . (Art. 171.)

Ruling. An owner of an orchard which has reached an income-producing stage is entitled to deduct from gross income in his annual tax returns an annual allowance for depreciation, based upon the capital invested, which comprises the original purchase price of the trees together with the necessary expenditures incurred in bringing them to the producing age; and the rate of depreciation is to be determined by the average life of the trees under normal conditions. (C. B. 2, page 130; O. 797.)

Losses.—

Regulation. Losses incurred in the operation of farms as business enterprises are deductible from gross income. . . . . (Art. 145.)

Depreciation of fruit trees and the computation of deductible loss in event of death.—

Rulings. Receipt is acknowledged of your letter dated February 24, 1920, quoted here as follows: "I have a 20-acre prune orchard of two thousand (2,000) six-year-old trees. Last year, two hundred and fifty (250) of them died from some unavoidable cause. Am I allowed any depreciation on same?"

In reply, you are advised that the loss sustained by the killing of the trees is the cost of the trees killed, and the amount of such loss is deductible from your income for the taxable year 1919. If the orchard had not reached an income producing stage at the time the trees were killed, the cost of the trees would be the initial cost, or fair market value on March 1, 1913, if the trees were acquired prior to that date, plus the capitalized expenditures incurred in bringing them to maturity. In the event the orchard had reached the income producing stage at the time the trees were destroyed, the cost would be the initial cost or fair market value as of March 1, 1913, plus the capitalized expenditures incurred in bringing them to maturity less depreciation sustained.

The basis of computing depreciation is the cost of the trees at the time the orchard has reached an income producing stage, including initial cost and capitalized expenditures incurred in bringing them to maturity, and the rate of depreciation is to be determined by the average life of the trees from the income producing stage under

normal conditions. (Letter to C. M. McKinney, Walla Walla, Washington, signed by G. V. Newton, Acting Assistant to the Commissioner, by S. Alexander, Head of Division, dated March, 1920.)

In the case of orchards and vineyards acquired subsequent to March 1, 1913, and later destroyed, any deduction for loss should be confined to the amounts of capital originally invested in the growing trees and in the new nursery stock which was totally destroyed and the amount expended from date of acquirement to date of destruction in an endeavor to bring such trees and stock to an income-producing stage, eliminating all expenditures on account of permanent improvements or on account of trees and vines the growth of which was merely retarded and not entirely destroyed. (C. B. 2, page 127; O. D. 374.)

Attorney's fees deductible.—

Ruling. A tenant at work on the farm of a taxpayer was injured. In defending suit for damages on account of negligence the taxpayer incurred expenses for attorney's fees.

It is held that if the taxpayer was engaged in farming he was carrying on a trade or business, and that the attorney's fees constituted compensation for personal services actually rendered which is deductible as an ordinary and necessary expense. If the farm was rented, the amount so paid is deductible as a business expense incident to the earning of the rent. (B. 48-21-1947; O. D. 1117.)

Deterioration or loss by casualty.—

Regulation. . . . . If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage shall be allowed, except as such shrinkage may be reflected in an inventory if used to determine profits. The total loss by frost, storm, flood, or fire of a prospective crop is not a deductible loss in computing net income. . . . . (Art. 145.)

However, if the farmer's accounts are kept on the accrual basis, he receives credit, in effect, for the loss of the destroyed crop because it appears in neither sales nor inventory (which enter into the determination of his gross income), while the cost of the crop is included among the deductions. If the accounts are kept on the cash basis, the destroyed crop would not appear among the gross income (sales of produce) but the cost would be allowed as a deduction.

Loss from death of stock raised on farm.—

Regulation. . . . . A farmer engaged in raising and selling stock, cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm, except as such loss is reflected in an inventory if used.

Loss from death of stock purchased.— If live stock has been purchased for any purpose, and afterwards dies from disease, exposure, or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such stock, less any depreciation sustained and allowable as a deduction in computing net income, with respect to such perished live stock, and less also any insurance or indemnity recovered, may be deducted as a loss. The actual cost of other property, less depreciation sustained and allowable as a deduction in computing net income, destroyed by order of the authorities of a State or of the United States, may in like manner be claimed as a loss; but if reimbursement is made by a State or the United States in whole or in part on account of stock killed or property destroyed, the amount received shall be reported as income for the year in which reimbursement is made. The cost of any feed, pasturage, or care which has been deducted as an expense of operation shall not be included as part of the cost of the stock for the purpose of ascertaining the amount of a deductible loss.

Inventory method when used will reflect loss.— If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. . . . . (Art. 145.)

Inventories of livestock raisers and other farmers.—

Regulation. (1) Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis, which necessitates the use of opening and closing inventories for the year in which the change is made. There should be included in the opening inventory, all farm products (including live stock), purchased or raised, which were on hand at the date of the inventory, but inventories must not include real estate, buildings, permanent improvements, or any other assets subject to depreciation.

(2) Because of the difficulty of ascertaining actual cost of live stock and other farm products, farmers who render their returns upon an inventory basis may at their option value their inventories

for the current taxable year according to the "farm-price method" which provides for the valuation of inventories at market price less cost of marketing. If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of pricing inventories from that employed in prior years, the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year. If such valuation of the opening inventory for the taxable year in which the change is made results in an abnormally large income for that year, there may be submitted with the return for such taxable year an adjustment statement for the preceding year based on the "farm-price method" of valuing inventories; upon the amount of which adjustments the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such preceding year.

(3) Where returns have been made in which the taxable net income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding year in which such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into agreement with the opening complete inventory for the current taxable year. If necessary to reflect the income, similar adjustments may be made as at the beginning of the preceding year, and the tax, if any be due, shall be assessed at the rate of tax in effect for such year. (Art. 1586.)

Ruling. Article 1586 of Regulations 45 (1920 edition) revokes all previous rulings and instructions inconsistent therewith. It is not permissible for farmers, in changing to the inventory basis of making their returns, to make adjustments by calculating their net income for the current taxable year without taking as a credit the inventory of live stock, crops, and other products at the beginning of the year in accordance with the instructions on page 4 of Form 1040-F. (C. B. 4, page 54; O. D. 939.)

Treasury Decision 3104 does not require adjustment of taxes for years prior to 1917, in cases in which farmers change to the inventory basis in rendering their income tax returns for the current taxable year because in most cases records for such prior years are not available. If, however, adequate records for the years 1915 and 1916 are available, adjustments may be made for those years also. (C. B. 4, page 53; O. D. 802.)

It is not contemplated by Treasury Decision 3104 that farmers must obtain formal permission in order to change the basis of their returns from that of receipts and disbursements to that of an inventory basis. The use of opening and closing inventories for the year in which the change is made is, however, necessary, and there must

be submitted with the return for the current taxable year an adjustment sheet for 1917 and each year thereafter (prior to the year in which the change is made) based on the inventory method, upon the amount of which adjustments the tax shall be assessed and paid (if any be due) at the rate of tax in effect for each respective year. (C. B. 4, page 53; O. D. 841.)

The Treasury makes it as easy as possible for a farmer to change from a cash receipts to an accrual basis. If taxpayers have not taken inventories heretofore, the information required for the years prior to the current year may be supplied by estimating their inventories as of past dates.

Farm price method.—Article 1586[3] permits farmers to use *market* as the basis of inventory (in contrast with *cost or market*). This is apparently the only case in which appreciations would be taxed before realization, excepting when dealers in securities use the "market value" basis of inventorying permitted by article 1585.

Rulings. The purpose of the adjustment sheets required in article 1586, Regulations 45, is properly to allocate over the period from 1917 to date, the net difference in gain or loss due to changing from a cash basis to an inventory basis.

Opening and closing inventories for these years are first ascertained from the best source of information available, and the gross income of each year is adjusted by adding or subtracting, as the case may be, the additional gain or loss due to the difference between the opening and closing inventory in each year. A separate adjustment sheet should be made for each year from 1917 to date, in order that the sheet for each year may be attached to the return for that particular year. The net income is then adjusted conformably, and from this information the tax on each return is recomputed in this office at the rate at which the tax was originally computed. (B. 47-21-1928; O. D. 1105.)

Florists are not required to use inventories of growing plants for the purpose of calculating their net income for income tax purposes and should not compute the cost of goods sold during the year by using an inventory value of growing plants on hand at the beginning and end of the taxable year. (B. 34-21-1774; O. D. 995.)

It should be noted that farmers are entitled to the benefit

[3] See page 1416.

of section 204 of the 1921 law[4]; and if a net loss is sustained in any taxable year, beginning after December 31, 1920, the loss may be applied against the profits of the succeeding year and any excess of such loss may be applied against the profits of the next succeeding year.

Farmers who keep books.—The regulations provide that farmers who keep books according to an approved system may prepare their returns therefrom.

Several accounting systems for farmers have been devised. It is claimed that with little effort a correct record of the financial position and income and expenses of farmers may be kept.[5] The claims sound rather optimistic to the author.

Operating a farm is conducting a business for profit. Accurate results cannot be ascertained unless inventories are taken. Otherwise a farmer who is breeding stock and accumulating a large herd might show no income (or a loss) for several years and then, if he were to dispose of all his stock in one year, he would have to pay an excessive tax, although the profit would be properly distributable over several prior years.

The accurate and fair method would be to inventory his stock annually and pay the tax on the profit as it accrues annually and as shown by his books.

Use of form 1040F optional.—

RULING. The use of form 1040F is optional since it is designed merely to assist farmers in computing their net income. Therefore, it is unnecessary to file same where the taxpayer has made return and paid the taxes due. (C. B. 1, page 71; O. D. 266.)

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[4] **[Former Procedure]** Under section 204 of the 1918 law, if a net loss was sustained in any taxable year, beginning after October 31, 1918, and ending prior to January 1, 1920, such net loss was deductible from the profits of the preceding year or of the succeeding taxable year. Farmers, of course, if their fiscal year ended at any date between January and October, were not entitled to the benefit of section 204. Presumably most farmers make up their accounts on the basis of the calendar year, so that there was no discrimination against them, as was the case with many corporations.

[5] For details of a system see the *Magazine of Wall Street* for January 24, 1920, pages 392-3. A bibliography on farm accounting will be found in *Accountant's Index*, 1921, pages 46-73, 787, 788.

The following statement appears as instruction 7 on form 1040:

If you are a farmer or a farm owner renting your farm out on shares and keep no books of account, or keep books on a cash basis, obtain from the Collector, and attach to this return, Form 1040F, Schedule of Farm Income and Expenses. Enter the net farm income as Item 5, page 1 of the return. If your farm books of account are kept on an accrual basis, the filing of Form 1040F is optional. Report income from salaries, interest, rents, sales of property, etc., in Items 1 to 7 of the return.

PART V

MISCELLANEOUS TAXES

CHAPTER XL

FEDERAL ESTATE TAX

This tax, which forms Title IV of the Revenue Act of 1921, bears at least the merit of antiquity as a part of federal taxation, although some authorities think that this source of revenue should be left exclusively to the states. As long ago as 1797 there was imposed, under the Stamp Act of that year, an inheritance tax. This latter act was in force for five years. It was a war measure, as have been all subsequent inheritance tax acts. The Civil War was responsible for the next law of this nature, imposed in 1862, with a life of eight years; while the Spanish-American War produced the Act of 1898 which remained in force for four years. Within the last decade appeared the Revenue Act of 1916, Title II of which was termed an "Estate Tax," amended twice in 1917 (March 3 and October 3), and the Act of February 24, 1919, (known as the Revenue Act of 1918), the last prior to the one herein discussed.

It will be noticed that the Stamp Act of 1797 imposed an "inheritance tax." This term cannot be used in relation to the existing tax. True, it is a tax on the transfer of property which passes by inheritance, but it is distinctly a tax on the transfer and not on the manner of that transfer. The law, section 401, states that the tax "is hereby imposed on the *transfer* of the net estate . . . ." It further imposes a tax on the transfer of property by will or trust in anticipation of death. It is tentatively assumed that all property transferred within two years prior to death has been transferred to avoid the tax, and the amount of any such property must be included in the return of the gross estate, unless transferred by "a bona fide sale for a fair consideration in

money or money's worth,"[1] or unless any such transfer being made without valuable consideration within two years of decedent's death, can be established not to have been made in contemplation of death. In any case, the property must be described in the return and its value shown therein. The burden of proof regarding the non-inclusion of the value of such property in the gross estate lies with the legal representatives of the decedent. The latter are likewise responsible for the filing of the notice, the return itself,[2] and the payment of the tax.[3]

The tax is computed on the value of the net estate at varying rates and in graduated blocks or brackets. Herein it differs from most of the state taxes of this nature which are based on the several distributive shares of the net estate, different exemptions being allowed according to the status of the beneficiaries in relation to the decedent. In the federal tax the total net estate is taxed, the net amount having been arrived at in accordance with the regulations hereinafter mentioned, less, in the case of resident estates, a single exemption of $50,000. It is obvious, therefore, that resident estates whose net transfer values do not amount to $50,000 are not subject to the estate tax.[4]

The law dealing with the estate tax forms sections 400-411 of the Revenue Act of 1921, which is effective from November 23, 1921. Prior to this date, the 1918 law was in effect. The latest regulations are known as Regulations 37 and deal with the 1918 law. Regulations for the 1921 law have not yet been issued.

Summary of Law

Section 400. Definitions.
Section 401. Rates of tax.
Section 402. Determination of gross estate.

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[1] 1921 law, section 402 (c).
[2] 1921 law, section 404.
[3] 1921 law, section 407.
[4] See Reg. 37, Art. 77. See page 1497.

Property owned by decedent.
Dower and curtesy.
Transfers in contemplation of death.
Interest of decedent in joint estate.
Property passing under a power of appointment by will or deed.
Insurance on life of decedent payable to his estate or to individual beneficiaries in excess of $40,000.

Section 403. Determination of net estate (deductions allowable).

Funeral and administration expenses; claims, etc.
Decedent's share in estate of prior decedent taxed within previous five years.
Charitable bequests, etc.
Specific exemption of $50,000 (for residents only).

Sections 404, 405. Returns, by whom and when made.
Sections 406, 411. Tax, when due and by whom payable.

Definitions.—The following definitions appearing in section 2, Title I, of the Revenue Act of 1921, are applicable to the estate tax:

"Person" includes partnerships and corporations as well as individuals;

"Corporation" means associations, joint-stock companies, and insurance companies;

"United States" means, in a geographical sense only the states, the Territories of Alaska and Hawaii, and the District of Columbia.

"Taxpayer" means any person, trust, or estate subject to taxation under this act.

"Executor" is defined as "the executor or administrator of the decedent, or, if there is no executor or administrator, any person in actual or constructive possession of any property of the decedent" (law, section 400).

Rates of Tax.—The rates of tax imposed by the 1921 law are identical with those under the 1918 law. The exemption of $50,000 applies only to residents.

Law. Section 401. **That, in lieu of the tax imposed by Title IV of the Revenue Act of 1918, a tax equal to the sum of the following**

percentages of the value of the net estate (determined as provided in section 403) is hereby imposed upon the transfer of the net estate of every decedent dying after the passage of this Act, whether a resident or nonresident of the United States:

1 per centum of the amount of the net estate not in excess of $50,000;

2 per centum of the amount by which the net estate exceeds $50,000 and does not exceed $150,000;

3 per centum of the amount by which the net estate exceeds $150,000 and does not exceed $250,000;

4 per centum of the amount by which the net estate exceeds $250,000 and does not exceed $450,000;

6 per centum of the amount by which the net estate exceeds $450,000 and does not exceed $750,000;

8 per centum of the amount by which the net estate exceeds $750,000 and does not exceed $1,000,000;

10 per centum of the amount by which the net estate exceeds $1,000,000 and does not exceed $1,500,000;

12 per centum of the amount by which the net estate exceeds $1,500,000 and does not exceed $2,000,000;

14 per centum of the amount by which the net estate exceeds $2,000,000 and does not exceed $3,000,000;

16 per centum of the amount by which the net estate exceeds $3,000,000 and does not exceed $4,000,000;

18 per centum of the amount by which the net estate exceeds $4,000,000 and does not exceed $5,000,000;

20 per centum of the amount by which the net estate exceeds $5,000,000 and does not exceed $8,000,000;

22 per centum of the amount by which the net estate exceeds $8,000,000 and does not exceed $10,000,000; and

25 per centum of the amount by which the net estate exceeds $10,000,000.

REGULATION. For the purpose of computing the tax, the net estate is divisible into blocks, each block being taxed at a different and increasing rate. The preceding table gives the amount at the various blocks and the applicable rate of tax under each of the taxing acts. For example, the tax upon the net estate of $1,240,000 of a decedent dying on or after February 25, 1919, would be computed as follows:

Amount of first block	$50,000 at	1 per cent	$500
Amount of second block	100,000 at	2 per cent	2,000
Amount of third block	100,000 at	3 per cent	3,000
Amount of fourth block	200,000 at	4 per cent	8,000
Amount of fifth block	300,000 at	6 per cent	18,000
Amount of sixth block	250,000 at	8 per cent	20,000
Remainder	240,000 at	10 per cent	24,000
Total net estate	$1,240,000	Total tax	$75,500

There is subjoined a table for ascertaining the tax without the detailed computation given above. An illustration of its use is as follows. The net estate of a decedent dying on or after February 25, 1919, amounts to $1,240,000. By reference to the table it will be seen that the last complete block prior to this amount is $1,000,000, and that the total tax on a million dollars under the rates in force amounts to $51,500. Upon the remainder of the estate, $240,000, the tax is computed at the rate contained in the following line, or at 10 per cent. The tax on this amount is consequently $24,000. The following result is thus obtained:

Total tax on	$1,000,000	$51,500
Tax on	240,000	24,000
Total	$1,240,000	$75,500

TABLE FOR COMPUTING ESTATE TAX

Net estate			1			2			3			4		
			Date of death											
			Sept. 9, 1916, to Mar. 2, 1917, inclusive (Revenue Act of 1916)			Mar. 3, 1917, to Oct. 3, 1917, inclusive (Amendment)			Oct. 4, 1917, to Feb. 24, 1919, inclusive (Revenue Act of 1917)			On and after Feb. 25, 1919 (Revenue Acts of 1918 and 1921)		
Exceeding	Not Exceeding—	Amount of block	Rate (per cent)	Tax	Total	Rate (per cent)	Tax	Total	Rate (per cent)	Tax	Total	Rate (per cent)	Tax	Total
....	$50,000	$50,000	1	$500	$500	1½	$750	$750	2	$1,000	$1,000	1	$500	$500
$50,000	150,000	100,000	2	2,000	2,500	3	3,000	3,750	4	4,000	5,000	2	2,000	2,500
150,000	250,000	100,000	3	3,000	5,500	4½	4,500	8,250	6	6,000	11,000	3	3,000	5,500
250,000	450,000	200,000	4	8,000	13,500	6	12,000	20,250	8	16,000	27,000	4	8,000	13,500
450,000	750,000	300,000	5	15,000	28,500	7½	22,500	42,750	10	30,000	57,000	6	18,000	31,500
750,000	1,000,000	250,000	5	12,500	41,000	7½	18,750	61,500	10	25,000	82,000	8	20,000	51,500
1,000,000	1,500,000	500,000	6	30,000	71,000	9	45,000	106,500	12	60,000	142,000	10	50,000	101,500
1,500,000	2,000,000	500,000	6	30,000	101,000	9	45,000	151,500	12	60,000	202,000	12	60,000	161,500
2,000,000	3,000,000	1,000,000	7	70,000	171,000	10½	105,000	256,500	14	140,000	342,000	14	140,000	301,000
3,000,000	4,000,000	1,000,000	8	80,000	251,000	12	120,000	376,500	16	160,000	502,000	16	160,000	461,500
4,000,000	5,000,000	1,000,000	9	90,000	341,000	13½	135,000	511,500	18	180,000	682,000	18	180,000	641,000
5,000,000	6,000,000	1,000,000	10	100,000	441,000	15	150,000	661,500	20	200,000	882,000	20	200,000	841,000
6,000,000	7,000,000	1,000,000	10	100,000	541,000	15	150,000	811,500	20	200,000	1,082,000	20	200,000	1,041,500
7,000,000	8,000,000	1,000,000	10	100,000	641,000	15	150,000	961,500	20	200,000	1,282,000	20	200,000	1,241,500
8,000,000	9,000,000	1,000,000	10	100,000	741,000	15	150,000	1,111,500	22	220,000	1,502,000	22	220,000	1,461,500
9,000,000	10,000,000	1,000,000	10	100,000	841,000	15	150,000	1,261,500	22	220,000	1,722,000	22	220,000	1,681,500
10,000,000	....	....	10	....	....	15	......	....	25	....	....	25	....	....

(Reg. 37, Art. 8.)

Description of taxable estates.—

REGULATION. The tax is imposed in the case of the estate of "every decedent," although, by reason of an exemption, the net estate of a resident decedent, in order to be taxable, must exceed $50,000. (See Sec. 403 (a) 4.) The estate of a nonresident decedent, however, is taxable if any part of it is situated in the United States. The statute takes no account of the citizenship of the decedent, but prescribes different rules according to whether the decedent was a "resident" or a "nonresident" of the United States. . . . . A "resident" is one who at the time of his death resided in the States, the Territories of Alaska or Hawaii, or the District of Columbia. All other persons are "nonresidents." . . . . (Reg. 37, Art. 4.)

The tax is imposed on the estate of every resident domiciled in the United States at the time of death, *quite apart from the question of nationality.* The application of the law to non-residents is shown concisely in the above regulation. Special regulations such as those concerning deductions, where non-resident estates are involved, are dealt with under their respective headings.

Definition of "resident."—

REGULATION. A person is a "resident" of the United States, for the purposes of this tax, only in case he has a *domicile* therein at the time of his death. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. A decedent who died while abroad will be presumed to be a nonresident, and the burden of proving the contrary rests upon the executor. (Reg. 37, Art. 5.)

In the 1921 act the definition of the term "resident" is also extended to citizens regarding whose property any probate or administration proceedings are had in the United States Court for China.[5]

No satisfactory conclusive or general definition of "resident" can be given. Intention plays a large part, and each case must be decided on its merits.

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[5] See page 1516.

Military exemption.—

LAW. Section 401. . . . . The taxes imposed by this title or by Title II of the Revenue Act of 1916 (as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917) or by Title IX of the Revenue Act of 1917, or by Title IV of the Revenue Act of 1918, shall not apply to the transfer of the net estate of any decedent who has died or may die from injuries received or disease contracted in line of duty while serving in the military or naval forces of the United States in the war against the German Government, or to the transfer of the net estate of any citizen of the United States who has died or may die from injuries received or disease contracted in line of duty while serving in the military or naval forces of any country while associated with the United States in the prosecution of such war, or prior to the entrance therein of the United States, and any tax collected upon such transfer shall be refunded to the estate of such decedent.

The intent of this section is as obvious as it is just.

While the above section includes only those affected by the late World War, it might be well made applicable to any person on active service generally in the military or naval forces. This attitude has been taken in Title II (income tax) in regard to pensions.[6] Doubt might exist as to just what is comprised under the term "military or naval forces of the United States." Help in this direction is given in the following definition:

REGULATION. . . . . The term "military or naval forces of the United States" includes, among other units, the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female. This exemption applies to any estate tax imposed, whether by the Revenue Act of 1916 or subsequent statutes. If the tax has been collected, the executor should make claim for refund. (Reg. 37, Art. 9.)

It would appear that relief from taxation under the statutes mentioned is intended to apply merely to those persons employed directly by the government in the prosecution of the war, and no mention is made of the large army of non-combatants who, while not directly in government pay, were subject to the risks of death and disease in the service. Included

[6] Section 213 (b-9).

in this latter category might be the Red Cross workers whose duties entailed the same hardships and sufferings as those performed by the Army Nurse Corps, a body specifically mentioned in the regulation quoted above. The distinction is arbitrary and, in practice, might obviously work an injustice to those who helped in the World War. The attitude of the Department in excluding members of the Public Health Service from income tax exemption would indicate that the letter, rather than the spirit of the law, governs these exemptions.

Any collection made on the transfer of an estate exempt from taxation under this section, is subject to refund but the burden of proving such exemption lies with the executor. A formal claim must be made on form 793 as soon as the necessary supporting evidence can be secured. This evidence should consist of the following data:

Regulation. . . . . Where the decedent died while serving in the military or naval forces, but after the termination of the war with Germany, there should be submitted:

(1) Certificate of The Adjutant General, Surgeon General of the Navy, or commanding officer as above, stating the occurrence of death while in the service, and the cause of death.

(2) Affidavits or other evidence to show that the death resulted from injuries received, or disease contracted, while serving in the military or naval forces during the war with Germany.

Where the decedent died after discharge from the military or naval forces there should be submitted:

(1) Certificate of discharge from the service, or copy of such certificate.

(2) Certified copy of public record of death, showing cause of death.

(3) Affidavit of physician who attended decedent during last illness, setting forth the medical history of the decedent while under his treatment.

(4) Affidavits or other evidence to show that the death resulted from injuries received, or disease contracted, while serving in the military or naval forces during the war with Germany. . . . . (Reg 37, Art. 10.)

Claims for refund arising from military exemption.—In view of the fact that the granting of this exemption is retroactive, attention is particularly called to the following:

REGULATION. Prior to the passage of the Revenue Act of 1918 there was no military exemption from estate tax except with respect to the increase of rates imposed by the Revenue Act of 1917. The provision in the Revenue Act of 1918 granting the exemption is retroactive, and authorizes the refund of all estate taxes collected under the provisions of former acts from estates now entitled to the exemption. Where such taxes have been collected, the executor should file a claim for refund on Form 46, accompanied by the same evidence as is required in support of a claim for military exemption. (Reg. 37, Art. 11.)

Gross Estate—Individual Property

The intention of the lawmakers is to impose the tax upon what may be called the "realizable" value of the estate. Since the use of the word "realizable" might in some cases lead to abuses, the word "value" is used; but it is intended in all cases that the word is to mean the fair or market or reasonable or realizable value in so far as the aggregate net value, as determined, shall yield a tax fair to the government and fair to those upon whom it is imposed. Tax laws must be construed most strictly against the government.[7] This just principle is not of great importance when tax rates are low; but where tax rates reach 25 per cent it would be harsh, inequitable, and would lead to wholesale evasions if all doubtful questions were decided against taxpayers. Property for which there is no broad and active market must not be overvalued or the tax collected would be in excess of that which is intended. If an item of property were valued at $4,000 when the readily realizable value is $1,000, the actual tax rate would be 100 per cent instead of 25 per cent. These questions will be discussed in detail hereafter. At this point only the general principle is to be noted.

LAW. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—**

(a) To the extent of the interest therein of the decedent at the

[7] *Gould v. Gould*, 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211.

time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate; . . . .

The two regulations following are very complete and explicit and leave little room for doubt as to the items of property which should, or should not, be included in the gross estate of the decedent.

REGULATIONS. This provision is designed to include all property interests of the decedent, of whatever character. It is the commonest form of taxable transfer. As a basis for tax, there must be an actual, beneficial ownership in the decedent, not a bare legal title, or one held in trust. Thus, property actually devoted to religious or charitable purposes, and placed in the name of an individual solely for convenience in administration, is not included in his gross estate. The statute also includes only property rights existing in the decedent in his lifetime and passing to his estate. It consequently does not include a right which came into existence only after the decedent's death, such as a cause of action by statute for causing the death. The proceeds of such a cause of action should not be included in the gross estate, whether payable generally to the estate or to some specified class of persons, such as the widow or children.

The value of a vested remainder should be included in the gross estate. Nothing should be included, however, on account of a contingent remainder where the contingency does not happen in the lifetime of the decedent, and the interest consequently lapses at his death. Nor should anything be included on account of a life estate in the decedent. There should be included, however, the value of an annuity[8] payable to the decedent upon the life of a third person who survives him, and the value of an estate for the life of a person other than the decedent. . . . . (Reg. 37, Art. 12.)

SPECIFIC PROPERTY TO BE INCLUDED.—

REGULATION. Real property owned by the decedent, when situated in the United States, should be included in the gross estate, whether the decedent was a resident or a nonresident, and whether the property came into the possession and control of the executor or administrator or passed directly to heirs or devisees. Real property not situated in the United States should not be included, whether the decedent was a resident or nonresident. Where the decedent was a resident, all personal property owned by him should be included, wherever situated. Where decedent was a nonresident, so much of

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[8] For rules as to valuing such annuities and illustrations, see Reg. 37, Art. 20.

his personal property as was actually situated in the United States at the time of his death should be included. For further discussion of the rules relating to the estates of nonresidents, see Article 60.

A cemetery lot owned by the decedent is part of his gross estate, but its value is limited to the salable value of such part of it as is not designed for the interment of the decedent or members of his family. Rent which had accrued upon real property at the time of the decedent's death, whether then payable or not, is included in the gross estate. The amount of interest accrued upon bonds on the day of death, whether payable then or subsequently, should be included. All matured coupons, whether presented for payment or not, should be included. The value of notes or other claims held by the decedent should be included, though they are canceled by his will or appear to be barred by the statute of limitations. As to the valuation of notes or claims apparently barred, see Article 15, paragraph 3. All bonds, whether federal, state, or municipal, and whether or not containing a tax-free covenant, should be included.

Dividends, whether upon preferred or common stock, should not be included unless actually declared prior to the date of death. The amount of dividends upon stock which have been declared, but not paid, must be returned where the value of the stock at the time of the decedent's death does not reflect the dividends; that is, where the death occurs after the closing of the books of the corporation and the stock consequently sells "ex dividend." Where the death occurs before the closing of the books, the value of the stock reflects the dividend, and it should not be included.

Example: A 5 per cent dividend upon stock is declared March 1, payable on April 1 to stockholders of record on March 15. If the death occurred on March 10 and the market price on that day was 90, the value to be returned for both stock and dividend is 90, the dividend being reflected in the quoted price. If the death occurred on March 20, the books have been closed and the dividend is not reflected in the selling price. Under these circumstances the dividend must be returned in addition to the quoted price of the stock; and the proper return would be stock 90, dividend $5. (Reg. 37, Art. 13.)

Determination of value of property included in gross estate.—From the point of view of those responsible for the filing of estate tax returns, the question of the determination of values is, naturally, the crux of the whole situation. The regulations, full as they are in substance, cannot deal with every contingency that arises in fact. There are appraisal companies which, in order to secure business, advertise their ability to furnish appraisals which they guarantee

will be accepted by the Treasury Department. The guarantee carries the danger that an appraisal sufficiently high would always be acceptable to the Department. In other words, an appraisal company engaged on this implied basis would be working against the interest of the taxpayer in order that it might make good its initial claim as to acceptance of its appraisal. Instead of being an inducement to make an engagement, such an assertion should be a warning to the executor. Undeniably, expert advice should be sought where an estate is large, its affairs complicated, and its assets varied. Any advice tendered on a "money back if you're not satisfied" basis should be avoided.

Regulation. The value at which property included in the gross estate is to be returned for tax purposes is the value at the time of the decedent's death. Neither depreciation nor appreciation in value subsequent to the date of death is considered. The value to be ascertained is the market, or sale, value of the property. The highest price obtainable for the property within a reasonable period of the decedent's death is the value to be included. A sale of the property, however, in order to be accepted as the criterion of value, must be made in such manner as to insure the best price obtainable under existing circumstances. This requires (*a*) that the sale be made as a matter of business, and not merely in order to establish value; (*b*) that it be made in absolute good faith, with a view to realizing as high a price as possible; and (*c*) that reasonable care and skill be exercised to obtain such price. If one method brings better results than another, the better method must be employed.

For example, if individual sales of property are better adapted to procure a good price than auction sales, the price obtained at an auction sale will be accepted only after reasonable effort to find individual purchasers has been made. See further on this point Article 15.

Great care must be exercised by the executor to arrive at a fair valuation of every asset of the gross estate. (Reg. 37, Art. 14.)

The legal definition of the word "value" is by no means settled. The word is held to mean one thing in one law and something else in another law. Generally speaking, the government attempts to fix too high a value, and taxpayers fix too low a value, upon the property the value of which is difficult to determine. Some value in between the two is fair. There should be brought into the determination lawyers and

accountants whose wide experience and familiarity with actual values insure an equitable adjustment.

In view of the fact that many months may elapse between the determination of values for inclusion in the gross estate and their inevitable review by an officer of the Internal Revenue Bureau[9] it is necessary that all calculations and methods of computation used should be carefully preserved in a manner that will permit of easy reference. This is, indeed, called for,[10] but that it is an essential will be readily recognized by an executor who has to make good his estimates to satisfy the investigating officer at any length of time after they have been made. It would be well for all parties concerned if this lapse of time could be shortened so that administration of the decedent's estate could be speedily concluded and a distribution to the legatees made. Apparently, unnecessary expense and hardship is involved under existing conditions. A suggestion that a final assessment of the tax be made within sixty days of the filing of the return, presented to the Committee on Ways and Means prior to the passing of the Revenue Act of 1918, produced no tangible reform in this direction. Consideration of the following shows exactly how far the suggestion was acted on, taking the expression "as soon as practicable" at its putative worth in so far as the Department of Internal Revenue is concerned.

REGULATION. . . . . It is the purpose of the Bureau to make these investigations as soon as practicable after the filing of the return. Whenever there are special and urgent reasons for an early investigation, the collector should be notified in order that the case may be given special attention. Upon completion of the investigation the executor will be apprised by the examining officer of his findings, and will be given an opportunity to discuss the case and present such data as he may desire, to be considered by the Bureau in connection with the examining officer's report. Upon the completion of the review and audit by the Bureau of the return and the examining officer's report, the executor will be informed by letter from the Commissioner of the result of the audit. If the letter contains notification of an

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[9] Reg. 37, Art. 70.
[10] Section 410.

unpaid balance of tax, the executor should make payment to the collector. After the expiration of 30 days from receipt of the notification interest will accrue upon the excess tax at the rate of ten per centum per annum. If the executor wishes to file claim for abatement of any part of the excess tax, such claim must be filed within 30 days of receipt of notification, or he may pay the tax in order to prevent the running of interest, and submit claim for refund. (Reg. 37, Art. 79.

Valuation of property.—Guidance in determining values in accord with what is called for in section 402 (a) of the law, quoted above, is given in the ensuing regulations.

VALUATION OF CASH.—

REGULATION. . . . . (4) Bank deposits should be returned at the amount for which the bank would be liable if the deposit were withdrawn upon the date of the decedent's death. Interest which the bank agreed to pay upon condition that the money remain on deposit after the death should not be included. (Reg. 37, Art. 15.)

REAL ESTATE.—

REGULATION. (1) Where real property has been sold, the amount received will be taken as its value provided the sale was made within a reasonable period of the decedent's death, and in such manner as to insure the highest possible price. Where no sale has been made, the criterion of value is the best price which could have been obtained within a reasonable period of the decedent's death. The amount brought at an auction sale should be considered, but will be accepted only if it appears that there was no available method of obtaining a higher price. The assessed valuation of the property should be considered, but is not conclusive. All relevant facts and all elements of value should be considered in every case. . . . . (Reg. 37, Art. 15.)

The one consideration in determining values of real estate, and, in fact, of any other item of property to be included in the gross estate of the decedent, is to arrive at a figure acceptable to the examining officer and at the same time to act fairly by the estate. The regulation just cited is full of indeterminate expressions, any one of which might form a basis for controversy and possible revision of the value submitted by the executor. Definition of "a reasonable period," proof as to

what will be considered "a proper manner" of obtaining the highest price, establishment of the "best price" which could have been obtained, are all factors which, if utilized, should be supported by every possible shred of evidence likely to ensure their acceptance. It should be borne in mind that any haphazard estimate of value, or any item included which could not be substantiated by adequate evidence, might, if detected, lead to the discounting of other facts possibly of vital interest to the taxpayer.

The regulations are not the law. They can only be recognized as indicative of the interpretation of the law by the Bureau of Internal Revenue. They are of undeniable assistance in preparing returns which must satisfy that Bureau. The regulations should be followed in all possible respects. Improper or negligent methods of determining the reported values will be summarily dealt with. Slipshod valuations result in the Commissioner fixing values with an eye, always, to "highest price." Unless determined by bona fide sales, the fair value of real estate is, at best, a hypothetical proposition. In the absence of sale it would appear that the most acceptable method is to establish a value by appraisal conducted by reputable appraisers, and to submit such appraisals (three or more in number) in the form of affidavits. It is likely that such a procedure would be accepted without question. Care should be taken to instruct the appraisers as to the basis called for in the following:

Regulation. Where expert appraisers are to be employed, care should be taken to see that they are men of recognized competence with respect to the particular class of property involved. In order to facilitate the acceptance of the appraisal, appraisers should be employed whose competence is well established.

The basis to be employed in appraising articles of this character is what they would bring at a bona fide sale to individual purchasers, to dealers, or upon a well-advertised auction sale. If there has been an actual bona fide sale, the amount received may be returned as the value of the property. Where property is valued by legatees for purposes of distribution, such value will not necessarily be accepted. The original cost of the articles is not necessarily a proper

basis, on account of depreciation or appreciation in value. (Reg. 37, Art. 19.)

Cases have arisen where appraisers whose competence was unquestionable have been employed on valuations; yet the Treasury has refused to accept their valuations, although such valuations were accepted by the surrogate's court of the state in question and by the state tax commission.

The Treasury should initiate some procedure whereby co-operation with the appraisers appointed by the surrogate's court would be possible, thereby eliminating duplications which result in such disagreements as those referred to above.

Stocks and bonds.—

Regulation. . . . . (2) The value of stocks and bonds listed upon a stock exchange should be obtained by taking the mean between the highest and the lowest sale price upon the day of death, provided the sales were made in the regular course of business, and not for the special purpose of establishing value. If there were no sales upon the date of death, the price nearest to that date, and within a reasonable period thereof, either before or after death, should be taken. Such sale price obtains irrespective of the number of shares held by the estate. If the security was listed upon more than one exchange, the records of the exchange where the security is principally dealt in should be employed. If the decedent died on Sunday or a legal holiday, the business of the previous day will govern.

If the stock is not listed upon an exchange, but is dealt in actively by brokers or has other active market, the latest sale price prior to the day of death will govern. If there is no active market for the stock and no sales of it have been made within a reasonable period of the decedent's death, and in particular where it is closely held (stock of a "close corporation"), return should be made upon the basis of the value of the stock, as evidenced by the clear value of the excess of the assets of the corporation over its liabilities, and its earning capacity for the five years preceding the death of the decedent. Where the earnings of the corporation have been greater than a fair return on its invested capital, computed according to the nature of the business, and where the business is a going business, there should be added to the net value of the other assets of the business the value of the good will, computed in accordance with sound accounting principles. Where the earnings of the corporation have been less than a fair return on the invested capital, if the difference is material and the decreased earnings affect value, the net

worth of the corporation as disclosed by its balance sheet may be adjusted on a reasonable basis to allow for this decreased value. In all cases where stock of this character forms a principal asset, there should be submitted with the return, Form 706, a copy of the balance sheets for the five preceding years, and of the balance sheet on the day of death or the nearest date thereto, together with a statement of the net earnings of the invested capital for the preceding five years.

The full value of securities pledged to secure a loan should be included in the gross estate. If the decedent had a trading account with a broker, all securities belonging to the decedent held by the broker at the date of death must be included at their market value on that date. Securities purchased on margin for the decedent's account and held by the broker should also be returned at their market value on the day of death. The amount of the decedent's indebtedness to the broker will be allowed as a deduction from the gross estate. (Reg. 37, Art. 15.)

The foregoing formula may result in the determination of the fair value of stocks or bonds, but in many cases it is unsound and will not be sustained by the courts. In the case of listed stocks, the quotations or the actual transactions for one day may be misleading. The trend of the market may be up or down and the number of shares sold may be insufficient to fix conclusively the value of any considerable number of shares. If a decedent leaves 100 shares of United States Steel common stock, the formula in the regulation is fair; if the decedent leaves a large number of shares of an inactive stock, the sale of a few hundred shares may only be the starting point in determining the value of the greater number of shares. In the case of a "close corporation," the earnings for the preceding years may be a major factor in arriving at a fair price, but if there is an abnormal period during those years, or if there is a decided trend towards the end of the period, any buyer of the stock would give more weight to the probable earnings or losses following the date of death than to the results of any of the years preceding death.[11]

As an illustration, consider a close corporation in which

[11] For methods of arriving at fair value, see Chapter XLI, "Capital Stock Tax."

the estate is interested to the extent of 1,000 shares of 7 per cent non-cumulative preferred stock. A few isolated sales to employees or officers of the corporation have been effected at par. According to the book figures, the excess of liquid assets over liabilities shows a backing behind the preferred stock of $130 per share issued. The dividend has been regularly paid. The corporation also has an issue of common stock which is cared for by an excess of all assets over liabilities (exclusive of goodwill) and after providing for the preferred stock at par, in a sum representing over $83 per share. Earnings for five years averaged 12½ per cent on the common stock after allowing for 7 per cent on the preferred. According to earnings shown by these book figures, the preferred stock of this corporation would be worth at least par. By reason of the fact that the corporation is a "close corporation" and its ramifications are known only to the few directly interested, it would be a matter of considerable difficulty to find a purchaser for the 1,000 shares included in the estate. An intelligent investor would say "at what price can I purchase 7 per cent preferred shares in any well-known and quoted stock in a similar line of business?" By this means he knows he can buy an issue which he is able to dispose of readily and the price of which is regulated by the prevailing supply, demand, and general business conditions. He finds that the average price of such securities is 91. Why should he pay $100 for what he knows nothing about and which he might have some difficulty in disposing of, if need be, when he can get the same thing for $91 in a form more easily negotiable and the price of which is established on an accepted financial basis. The fundamental principle on which "fair value" is based demands the possibility of a willing buyer and a willing seller. In appraising values of stocks in close corporations strictly in accord with the regulations, it would seem that this principle may very easily be lost sight of and that an arbitrary figure may be established which, on consideration, does not represent a fair value.

Whatever other factors may obtain, it cannot be denied that the stock of a close corporation should never be valued in excess of the fair market price of shares of stock of corporations in a similar line of business according to quotations on the open market. Investigation has proven that the application of this principle shows how little the actual book value does reflect the fair market value of corporation stock generally. A comparison of the market price of stocks of sixty-one corporations with the book value of those same stocks arrived at by reference to the last preceding balance sheets, as published by the best-known authority, revealed that the average book value per share was $137.80, whereas the average selling price per share was $75.84. In other words, the selling price represented only 55 per cent of the book value, at or about the date selected.

While 55 per cent cannot be a constant relative factor as between the selling price of stock and its book value, the fact that it was so in the investigation mentioned, conclusively shows how far from being a "fair market value" would be any figure determined solely on a valuation of the corporate assets.

The principle, however, may well be used where circumstances allow of its introduction. The book value of corporations which issue similar stocks, together with the market value thereof, should be listed and the percentage of the latter to the former should be determined. This percentage should then be applied to the book value of the assets under consideration, and the resultant stock value per share should be utilized as the actual value or in support of a value computed under some alternative method.

Generally speaking, it will be found in practice that the valuation of holdings in close corporations presents a problem to be solved by a general review of conditions from without as well as from within. As has been mentioned before, "a revenue law cannot be made elastic enough to deal with unusual problems."[12] Recognizing this fact, the authors of the Revenue

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[12] *Excess Profits Tax Procedure,* 1921, page 338.

Act of 1921, of which the estate tax is Title IV, have, in Title III (sections 327 and 328) inserted relief clauses to cover cases where a literal interpretation of the law relating to the war-profits and excess-profits tax would work evident hardships on the corporation taxpayer. The spirit of compromise here offered might well be used in principle in the valuation of stocks and bonds for estate tax purposes.

While balance sheets of organizations which come under the category of close corporations are called for in substantiation of determined values of their stock, there would appear to be no reason why the component parts of the balance sheets should not have to be appraised as to value. In this event, and in submitting balance sheets in evident support of values arrived at, it would be necessary to show comparative figures depicting "fair value" as against "book value." A piece of real estate held for a number of years will, under normal circumstances, have a different value at the time of the decedent's death from the figure at which it was purchased. In fact, the whole list of items shown in a balance sheet, where such method of determining the value of stock is used, should be subjected to the same scrutiny for worth at the date required as are the items which are comprised in the gross estate itself and upon the same lines as are suggested for them.

Valuation of notes.—

Regulation. . . . . (3) Notes, whether secured or unsecured, will be presumed to be worth their full face value, plus accrued interest to the date of decedent's death, unless the executor establishes the right to return them at a lower valuation. Interest should be computed upon the basis of 365 days to the year. In the case of an unsecured note it must be shown by satisfactory evidence, in order to justify failure to include it, that the note is uncollectible, either in whole or in part, from the maker or other parties to the note, an account of the insolvency of the parties thereto, or other cause. Where the note is secured it must also be shown that the security is insufficient to satisfy it. Where a note appears to be barred by the statute of limitations its value must be included in the gross estate in the absence of proof that the liability has not revived by promise to pay or part payment, and also that the parties

liable refuse to pay the debt and intend to assert the defense. (Reg. 37, Art. 15.)

It will be observed that the above regulation demands the valuation of notes at their face value unless a right to establish a lower value is supported by satisfactory and sufficient evidence. This is a question which depends entirely on circumstances. When the decedent leaves a business in active running order, which is ultimately to be carried on continuously by his successors, the face value of the assets may well be maintained. In instances, however, when a liquidation of all or part of the assets is necessary, unless value has already been determined by sales, the items under this caption should be included in the gross estate at their readily realizable value at the time of death. Reference to the law[13] demands the inclusion "of all property, real or personal, tangible or intangible," at the "value" at the time of death. An interpretation of the law which differentiates as to the meaning of the term "value at time of death" as between the various properties involved, is an erroneous one. The value of bonds which are quoted on the active market is determined primarily by their yield and due date. These quotations are accepted by the Treasury Department in connection with their inclusion in the gross estate. The principle of ready realization being thus established, the same principle should apply to all assets.

Valuation of interest in business.—

Regulation. . . . . (5) Care should be taken to arrive at an accurate valuation of any business in which the decedent was interested whether as partner or proprietor. A fair appraisal as of the date of death should be made of all the assets of the business, tangible and intangible, and the business should be given a net worth equal to the amount which a purchaser, whether an individual or corporation, would be willing to pay therefor at a normal sale in view of the net value of the assets and the demonstrated earning capacity. Special attention should be given to fixing an adequate figure for the value of the good will of the business in all cases where the decedent

[13] Law, section 402, quoted on page 1432.

has not, for a fair consideration in money or money's worth, agreed that his interest therein shall pass at his death to his surviving partner or partners. (Reg. 37, Art. 15.)

Comments heretofore made regarding the valuation of real estate, stocks, and bonds apply as well to many other items of property. A careful audit of the accounts of a going business should be made and a detailed financial statement prepared. Each item in the balance sheet should be fairly valued.

Valuation of goodwill, patents, etc.—

Regulation. . . . . (6) The basis for valuation of intangible assets of this character is the present worth of the estimated future earnings of the exclusive right during the rest of its existence. The return received by the decedent should be considered in estimating future earnings. (Reg. 37, Art. 15.)

The formula laid down in the foregoing regulation regarding the value of goodwill is a sound one in all cases when goodwill is the subject of sale. When an active partner dies, the value of goodwill is usually overestimated. The greater the personal interest of a decedent in a going business, the less the goodwill is worth.

The latter part of the regulation is not clear. Frequently goodwill under partnership agreements passes to the surviving partners without valuation. In such cases the decedent has divested himself of any interest in the goodwill and it is difficult to see the importance of ascertaining the value which he might have obtained for it if the partnership agreement had provided otherwise. The profit a man might, but does not realize is hardly taxable as property at his death. Of course if, in contemplation of death, a transfer of valuable goodwill should be made within two years before a decedent's death, the transaction would be open to question, as would be any other transfer similarly made.

The following digest of a memorandum issued by the Committee on Appeals and Review[14] indicates the methods of

[14] Method of obtaining value of intangible assets, C. B. 2, page 31; A. R. M. 34.

computation of goodwill values acceptable to the Bureau of Internal Revenue.

BRANDS. Take price at which article under specific brand sold as against similar article with no brand. Difference multiplied by number of units sold during given period equals profits attributable to use of brand. Do this for a sufficient number of years to give a constant figure and capitalize result at 20 per cent.

BRANDS OR GOODWILL, etc. (1) Take known cash price at which goodwill, or brand, etc., may have been sold. Compare business done by vendor with business done by concern under review. A proportionate value can thus be established.

(2) Take average earnings for five years, apply 10 per cent of this to tangible assets and apply residue, at five years' purchase, to goodwill.

In case of a business not subject to fluctuations or manufacturing article of daily necessity, reduce return on tangibles to 8 or 9 per cent and capitalize residue for goodwill at 15 per cent instead of 20 per cent.

Representative periods should be used in arriving at adjustments. Years showing extraordinary factors to be eliminated. In capitalizing earnings, percentage shown by the return on actual cost of the business should be considered. If earnings at one of the figures suggested above is in excess of such percentage, the smaller figure should be used.

This memorandum was further supplemented[15] by the suggestion that in determining net earnings under the third paragraph above, a reasonable amount on account of salaries for owners actively engaged in the business be deducted.

The formula set forth in article 15 above is sound when applied to the valuation of patents. It is not the same as the formula prescribed by the income tax unit of the Bureau of Internal Revenue for the valuation of goodwill (quoted above). As is the case with stocks of close corporations and goodwill, prospective buyers always attach much importance to the probable future earnings of the properties they buy.

VALUATION OF ACCOUNTS RECEIVABLE.—

REGULATION. . . . . (7) A fair valuation for assets of this character at the time of death should be fixed by the executor according to the best information available to him at the time of

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[15] C. B. 4, page 43; O. D. 937.

making return. A right of action which died with the decedent should not be included in the gross estate. (Reg. 37, Art. 15.)

Accounts receivable should be valued either on the basis of a going business or of a business in liquidation. If the business is being continued and periodical audit reports are available, there is little need to go behind the book value. Should the contrary be the case, a verification of the accounts should be made by direct correspondence with the debtors where necessary, and every care should be exercised in the determination of their collectibility or otherwise. Claims or judgments should not be accepted at face value without due scrutiny as to age and possible collectibility.

Valuation of furniture, jewels, etc., and growing crops.—

Regulations. . . . . (8) For the method of valuation to be employed in the case of household furniture and personal effects see Articles 16 to 19. With respect to all other tangible property the executor should endeavor to arrive at the sound and actual value at the day of death. Where such property is subsequently sold the sale price must be returned if the sale was a bona fide sale and for the best price obtainable. In the case of growing crops the executor should ascertain from expert opinion what the value of the growing crop was on the day of death, as evidenced by subsequent yield and crop prices. Where the crop is matured the value is the value of the crop unit on the day of death for the entire yield, less the cost of harvesting and marketing. Where the crop is not matured these factors should be considered; and the opinion of those expert in such matters should be ascertained as to what the crop was reasonably worth as a growing crop on the day of death. (Reg. 37, Art. 15.)

When the value of the personalty involved is less than $2,000, the detailed lists may be prepared by the executor personally. A room by room appraisal is desirable; and all the articles should be named specifically, except those of small value, such as common bric-a-brac or cheap books. A separate value should be given for each article named, except that the values of a number of articles contained in the same room may be grouped. The value of an article worth more than $50 should be stated separately. Such an entry as the following would be acceptable:

Dining room: Table, six chairs, three pictures (common prints), value $75; sideboard, $60; total, $135. (Reg. 37, Art. 17.)

Particular care is needed in arriving at the value of growing crops. The knowledge of subsequent realization, most probably available by the time the executor is making up the return, may unduly influence the ultimate determination of the value of the growing crop at the time of decedent's death. Particularly is this the case should the market fall below anticipated figures and so make the valuation appear too high. The appraisal must be made and based entirely on conditions and estimates obtaining *at the date of death* and values fixed in accord therewith, or, if possible, on the basis of sales of similar standing crops effected at that time. All charges necessary to the harvesting and marketing may be deducted from an appraisal based on an estimated worth. When the appraisal is made on comparative figures based on sales of similar standing crops, these costs will not generally be deductible. Such a sale is usually conditional on the vendee removing and marketing the ultimate crop.

If custom supports the procedure—as, for instance, in tobacco farming, where the aggregate cost of sowing, tending, harvesting, and depositing under cover (but not including picking and sorting) is considered the inventory figure of the year's crop—the value of the standing crop could very easily be estimated. The value at any given date would be the cost up to that date. In any case, and under whatever circumstances the valuation of a ground crop is determined, such valuation should be supported by affidavits from responsible people in the same line of business testifying that the method employed is in accord with prevailing customs in the trade and that the result so obtained fairly represents the value of the crop included in the gross estate.

Other regulations bearing on valuation follow:

Regulations. Executors and administrators are required to have careful appraisal made of all household and personal effects of the decedent, and to furnish in duplicate detailed lists and affidavits in the manner directed below. No distribution of such effects may be made until the lists and affidavits have been filed with the collector, and, if deemed necessary, sufficient time afforded the Bureau to have

personal inspection made by an official appraiser. Where it is desired to distribute or sell all the property in advance of the filing of the return, the lists and affidavits should be filed with the collector, together with a letter stating when it is desired to effect distribution. If personal inspection by an internal-revenue officer is not deemed necessary, a waiver of such examination will be sent to the executor, who may thereupon proceed with distribution. (Reg. 37, Art. 16.)

The foregoing regulation is not unreasonable if executors are not unduly hampered in making distributions. The law is silent on this point and no penalty is imposed. In practice distribution should be supervised in such a way as to satisfy the Treasury that the full value of the estate is reported for taxation.

Regulations. . . . . If there should be included in the lot, however, jewelry or silverware of more than ordinary value, or articles having a marked artistic value, the executor must furnish an appraisal by persons thoroughly qualified by training and experience to judge of the value of such articles.

In the case of effects having a total value of less than $2,000, the executor may furnish as an alternative requirement a sworn estimate in duplicate of the approximate total value of the property by a professional appraiser of recognized standing and ability, or by a dealer in the class of personalty involved.

In addition to the lists or estimates described above, the executor must furnish in duplicate his affidavit as to the completeness of the lists and the qualification of the appraiser. (Reg. 37, Art. 17.)

When the value of the effects is more than $2,000, detailed lists must be furnished, prepared by professional appraisers of recognized competence, or by dealers in the particular classes of personalty involved. The lists must be prepared in the same detail as that indicated above for the executor's list. Where the personalty includes jewelry, silverware, or like articles, except in cases where the value of these items is insignificant, the appraisal of a reputable dealer or appraiser of jewelry must be furnished.

In the case of articles having marked artistic value, such as paintings, engravings, etchings, statuary, vases, oriental rugs, or antiques, the appraisals of experts will be required. The description of such articles should be fully given. Where paintings having artistic value are listed, the size, subject, and artist should be named. In the case of oriental rugs, the size, make, age, etc., should be given. The weight in ounces of each article of silverware should be stated. With the duplicate lists there must be filed the executor's affidavit as to the completeness of the list and the qualifications of the appraisers. (Reg. 37, Art. 18.)

(For Regulation 37, article 13, see page 1433.)

The valuation of such miscellaneous property, in excess of $2,000, as may come under the last four articles quoted from the regulations is purely a matter of expert appraisal.

A point that requires particular attention in the valuation of household effects is to differentiate between property of this description owned by a surviving husband or wife individually, and that owned by the decedent.

Ruling. Household effects and like personalty used by husband and wife in the marriage relation are presumed to be the property of the husband, and, in the absence of sufficient evidence to rebut this presumption, must be returned as portion of his gross estate.[16]

It is pointed out by the Commissioner that a bare statement from the wife claiming the property is not sufficient; the burden of establishing the claim is thrown upon her. When the wife owned articles of household furniture before marriage, purchased them out of her separate funds or received them as gifts from others, if her claim is supported by proven evidence, such effects need not be included in the gross estate of the husband. The Commissioner further says:[17]

Ruling. The following proposition has been announced by the courts and is believed by this office to be sound. To constitute a valid gift there must be an absolute transfer of the property from donor to donee, taking effect immediately and fully executed by a delivery of the property to the donee, and the acceptance thereof by the donee. It is essential that the transaction should be fully executed by the delivery of the property to the donee, or to some person for him. In several States, statutes have been enacted providing that no gift, except by deed or will, shall be valid unless actual possession shall come to and remain with the donee, or his agent, and if the donee or donor reside together at the time of the gift, possession by the donee at their place of residence is not a sufficient possession within the meaning of statute.

Community property and other property in which there are joint interests.—In applying the tax levied under this title, consideration must be given to decisions of state

[16] T. D. 2529.
[17] T. D. 2529.

courts construing local statutes. Particularly is this true in connection with community property.[18] A test case, in so far as the California statutes are concerned, is found in the United States District Court, Northern District, California.[19] The question before the court was as to there being a transfer of any estate, under the California law, when one-half of the community property became vested in the widow upon death of the husband. The court, in overruling a demurrer, in effect, held that a wife, under community property laws, no longer takes her interest in the community property as heir, and hence that her interest is not subject to the federal inheritance tax imposed on the transfer of a decedent's estate. The court said:

> The community property act of 1917 is valid as to community property acquired before its passage (*Arnett v. Reade*, 220 U. S. 311, 320, 31 Sup. Ct. 425, 426, 55 L. Ed. 477, 36 L. R. A. (N. S.) 1040), and if that act does not recognize in the wife a valid subsisting, vested interest and estate in the community property during the life of the husband, language is without meaning and legislation without avail. When the husband had the management and control of the community property, with the like absolute power of disposition as of his own separate estate, a decision that the wife had a mere expectancy was plausible, if unsound. . . . . In all the community property states, from the necessity of the case, the agency of the husband as head of the family is much broader, and his control and dominion over personal property much greater, than in the case of real property; but it has never been supposed that this difference lessens the estate of the wife in community personal property, or calls for a different rule of succession.

In so far as the life usufruct[20] in favor of a widow under the Louisiana Civil Code is concerned, it has been decided that such value is not deductible from the gross estate in computing the federal estate tax.[21]

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[18] For a full discussion of community property in relation to the Revenue Act of 1921, see pages 395-400.

[19] *Blum v. Wardell*, 270 Fed. 309.

[20] "The right of enjoying things belonging to another and of drawing from them all the profit and advantage they will produce without destroying or wasting their substance." (Funk and Wagnall's *New Standard Dictionary*.)

[21] T. D. 3222.

The matter of community property is dealt with generally and conclusively in the following:

RULING. In Washington, Arizona, Idaho, New Mexico, Louisiana and Nevada there should be included in gross estate, in computing the estate tax of a deceased spouse, one-half only of the community property of husband and wife domiciled therein; this is not based upon any statute enacted subsequent to March 1, 1913 and applies under estate tax acts prior to the Revenue Act of 1918.[22]

Texas is included in the same category as the states enumerated above.[23]

VALUATION OF ANNUITIES.—

REGULATION. Where the decedent was entitled to receive an annuity of a definite amount during the lifetime of another person, and the right constitutes an asset of his estate, the present worth of the annuity at the time of the decedent's death must be computed upon the basis of the expectancy of life of the other person. The table marked "A" [following] should be used for this computation. The amount of annual income should be multiplied by the figure in column 2 of the table opposite the number of years in column 1 nearest to the actual age of the other person.

Example: The decedent received under the terms of his father's will an annuity of $10,000 for the life of his elder brother. The brother at the decedent's death was 40 years 8 months old. By reference to the table the figure in column 2 opposite 41 years, the number nearest to the brother's age, is found to be 14.86102. The present worth of the annuity is therefore $148,610.20.

Where the decedent was entitled to receive the annuity during a specified number of years, the table marked "B" [following] should be used.

Example: The decedent received under the terms of his father's will an annuity of $10.000 for a period of 20 years, 15 of which had expired at the decedent's death. By reference to the table it is found that the figure in column 2 opposite 5 years, the unexpired portion of the 20-year period, is 4.45182. The present worth of the annuity is, therefore, $44,518.20 (4.45182 multiplied by 10,000).

Where the decedent was entitled to receive the entire income of certain property during the life of another or for a term of years, and where the rate of income is fixed by the instrument creating the trust or is definitely determinable at the time of the decedent's death,

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[22] T. D. 3138.
[23] T. D. 3071.

the average annual income which the property actually yields should be determined, and its present worth computed, as explained above in the case of annuities.

Example: The decedent's father placed $100,000 in trust, with directions that it be invested in state and municipal bonds and the entire income paid to the decedent during the life of his elder brother, who was 41 years old at the decedent's death. Before the decedent's death the money was invested in state and municipal bonds, and actually yielded a net return of $5,000 per annum. In this case the rate of income is definitely determinable. By reference to the table it is found that the present worth of an income of $5,000, dependent upon the life of a person 41 years of age, is $74,305.10 (14.86102 multiplied by 5,000).

Where the rate of annual income is not determinable, or where the decedent was entitled merely to the personal use of nonincome-bearing property, a hypothetical annuity at a rate of 4 per cent of the value of the property should be made the basis of the calculation.

Example: The decedent died before a fund of $100,000, of which he was entitled to receive the income during the life of a person 41 years old, had been invested by the trustees. The value of a hypothetical annuity of $4,000, dependent upon the life of such a person, is indicated by the table to be $59,444.08.

Where the decedent possessed a remainder interest in property subject to the life estate of another, and such interest constituted an asset of his estate, the present worth of the remainder interest at the time of death should be obtained by multiplying the value of the property at the time of death by the figure in column 3 of Table A opposite the number of years nearest to the age of the life tenant. Where the remainder interest is subject to an estate for a term of years Table B should be used.

Example: The decedent was entitled to receive property worth $50,000 upon the death of his elder brother, to whom the income for life had been bequeathed. The brother at the time of the decedent's death was 31 years old. By reference to the table it is found that the figure in column 3 opposite 31 years is 0.31262. The present worth of the remainder interest is, therefore, $15,631. (Reg. 37, Art. 20.)

Where annual income is not determinable, the basis of 4 per cent to be used in calculating the annuity is too low. Resort to it should not be made until every other evidence as to possible income from the source in question has been reviewed. For the last two years any "gilt edge" interest-bearing investment has yielded considerably more than 4 per cent.

Unless proof can be established to the contrary, the benefit is distinctly to the government and not to the taxpayer. For instance, the present worth of an annuity of $1 for twenty years at 4 per cent (Table B-2) is $13.59, whereas the same annuity at 8 per cent would show a present worth of $9.818. Granted that a straight annuity, providing as it does for the average rate of interest covering a period of years, can be estimated on a 4 per cent basis, nevertheless, in the hypothetical instance illustrated in the regulation, where $100,000 was at the disposal of the trustees for investment, it might well be that at the time of the decedent's death this sum could be invested in bonds yielding 5½ per cent to 6 per cent. The value under such circumstances should be based on actual market conditions rather than on hypothetical rates which would not represent the actual value at the date of decedent's death, which is the value called for in the law. It is of interest to note that the first tables showing present worth of life interests in personal property based on the same rate as those now in existence, 4 per cent, were promulgated by the Commissioner of Internal Revenue as long ago as December 16, 1898, (Spanish War Revenue Act, 1898). The Supreme Court of the United States expressed the opinion that "at the time this tax was collected (1899) 4 per cent was very generally assumed to be the fair value or earning power of money safely invested."[24]

Dower and Curtesy.—

LAW. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—**

(b) To the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower, curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy. . . . .

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[24] *Simpson v. United States*, 252 U. S. 547, 40 S. Ct. 367, 64 L. Ed. 700.

Table "A."

Table, single life, 4 per cent, showing the present worth of an annuity, or life interest, and of a reversionary interest.

1 Age.	2 Annuity, or present value of $1 due at the end of each year during the life of a person of specified age.	3 Reversion, or present value of $1 due at the end of the year of death of a person of specified age.	1 Age.	2 Annuity, or present value of $1 due at the end of each year during the life of a person of specified age.	3 Reversion, or present value of $1 due at the end of the year of death of a person of specified age.
	Annuity.	Reversion, or		*Annuity.*	*Reversion.*
0	$14.72829	$0.39507	51	$12.17919	$0.49311
1	17.30771	.29586	52	11.88408	.50446
2	18.69578	.24247	53	11.58531	.51595
3	19.15901	.22465	54	11.28325	.52757
4	19.41226	.21491	55	10.97789	.53931
5	19.55301	.20950	56	10.60982	.55116
6	19.61731	.20703	57	10.35931	.56310
7	19.62502	.20673	58	10.04630	.57514
8	19.61097	.20727	59	9.73131	.58726
9	19.53413	.21022	60	9.41474	.59943
10	19.45359	.21332	61	9.09765	.61163
11	19.36943	.21656	62	8.78052	.62382
12	19.28184	.21993	63	8.46412	.63600
13	19.19065	.22344	64	8.14888	.64812
14	19.09590	.22708	65	7.83552	.66017
15	18.99764	.23086	66	7.52476	.67212
16	18.89569	.23478	67	7.21699	.68397
17	18.79010	.23884	68	6.91298	.69565
18	18.68070	.24305	69	6.61301	.70719
19	18.56751	.24740	70	6.31716	.71857
20	18.45038	.25191	71	6.02612	.72976
21	18.32932	.25656	72	5.74003	.74077
22	18.20416	.26138	73	5.45928	.75157
23	18.07471	.26636	74	5.18402	.76215
24	17.94097	.27150	75	4.91463	.77251
25	17.80274	.27682	76	4.65125	.78264
26	17.65984	.28231	77	4.39383	.79254
27	17.51224	.28799	78	4.14286	.80220
28	17.35968	.29386	79	3.89858	.81159
29	17.20225	.29991	80	3.66071	.82074
30	17.03961	.30617	81	3.42900	.82965
31	16.87176	.31262	82	3.20258	.83836
32	16.69846	.31929	83	2.98024	.84691
33	16.51964	.32617	84	2.76106	.85534
34	16.33503	.33327	85	2.54366	.86371
35	16.14437	.34060	86	2.32795	.87200
36	15.94755	.34817	87	2.11384	.88024
37	15.74427	.35599	88	1.90115	.88842
38	15.53421	.36407	89	1.69107	.89650
39	15.31722	.37241	90	1.48540	.90441
40	15.09295	.38104	91	1.28432	.91214
41	14.86102	.38996	92	1.09024	.91961
42	14.62122	.39918	93	.90647	.92667
43	14.37356	.40871	94	.73687	.93320
44	14.11860	.41852	95	.58435	.93906
45	13.85713	.42857	96	.46182	.94378
46	13.58958	.43886	97	.36698	.94742
47	13.31698	.44935	98	.24038	.95229
48	13.03942	.46002	99	.00000	.96154
49	12.75716	.47088			
50	12.47032	.48191			

TABLE "B."

1 Number of years.	2 Present worth of an annuity of $1, payable at the end of each year, for a certain number of years.	3 Present worth of $1, payable at the end of a certain number of years.	1 Number of years.	2 Present worth of an annuity of $1, payable at the end of each year, for a certain number of years.	3 Present worth of $1, payable at the end of a certain number of years.
	Annuity.	*Reversion.*		*Annuity.*	*Reversion.*
1	$0.96154	$0.961538	16	$11.65229	$0.533908
2	1.88609	.924556	17	12.16567	.513373
3	2.77509	.888996	18	12.65929	.493628
4	3.62989	.854804	19	13.13394	.474642
5	4.45182	.821927	20	13.59032	.456387
6	5.24214	.790314	21	14.02916	.438834
7	6.00205	.759918	22	14.45111	.421955
8	6.73274	.730690	23	14.85684	.405726
9	7.43533	.702587	24	15.24696	.390121
10	8.11089	.675564	25	15.62208	.375117
11	8.76047	.649581	26	15.98277	.360689
12	9.38507	.624597	27	16.32958	.346816
13	9.98565	.600574	28	16.66306	.333477
14	10.56312	.577475	29	16.98371	.320651
15	11.11839	.555265	30	17.29203	.308319

REGULATION. The provision includes dower and courtesy and all interests created by statute in lieu thereof, although the estate or interest so created is different in character. The effect of the provision is to require the inclusion of the full value of the property, without deduction of the value of the interest of the surviving husband or wife. This rule does not apply to the estate of any decedent dying after September 8, 1916, and prior to 6:55 p. m., February 24th, 1919 (the effective date of Title IV of the Revenue Act of 1918), unless the property has its situs in a jurisdiction wherein dower, courtesy, or the statutory interest in lieu thereof, is subject to the payment of charges against the estate, and the expenses of its administration and is subject to distribution as part of the estate, or unless there has been an election to take property devised or bequeathed in lieu of dower, courtesy, or such statutory interest, and the property so taken has its situs in a jurisdiction by the laws of which it is subject to the payment of such charges and expenses, and to distribution as part of the estate. (Reg. 37, Art 21, as revised by T. D. 3165, May 18, 1921.)

Transfers by decedent in his lifetime.—Under ordinary circumstances it is somewhat difficult to substantiate the fact that a transfer of property, either by means of a trust or otherwise, made without consideration and within two years of death, was not executed in contemplation of death. This difficulty is not lessened by the burden of proof resting on the executor to show the contrary.

Law. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, whereever situated. . . . .**

(c) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act), except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title; . . . .

Regulations. A transfer made by the decedent in his lifetime, if made by way of gift, is taxable when made in contemplation of death, or intended to take effect in possession or enjoyment at or after the death of the transferor. No distinction is made between ordinary transfers and transfers involving the creation of a trust. Where a transfer, however, constitutes a *bona fide* sale for a fair consideration in money or money's worth, it is not taxable. In order to constitute such a *bona fide* sale, there must be a valuable consideration, as distinguished from love and affection. A sale implies the receipt of a price, in money or thing of value. The release of an existing claim, by way of accord and satisfaction, is not sufficient. The price must also be a fair equivalent for the property transferred. Where the price is not a fair one, the sale will not be considered to have been made *bona fide*. Such transfers are taxable whether made before or after September 8, 1916. (Reg. 37, Art. 22.)

The words "in contemplation of death" do not refer to the general expectation of death which all persons entertain. A transfer, however, is made in contemplation of death wherever the person making it is influenced to do so by such an expectation of death, arising from bodily or mental conditions, as prompts persons to dispose of their property to those whom they deem proper objects of their bounty. The cause which induces such bodily or mental conditions is immaterial; and it is not necessary that the decedent be in the immediate expectation of death. Such a transfer is taxable, although the decedent parts absolutely and immediately with his title to and possession of the property. Transfers made within two years of a decedent's death are presumed to be taxable if they are of a material part of his property and are in the nature of a final disposition thereof. Where a transfer is of this character, the executor must disclose the transfer in the return; but he may submit therewith evidence

that it was not made in contemplation of death. The executor must also return transfers by the decedent of a material part of his property to relatives, though made more than two years before his death; but he need not list them as taxable if he contends otherwise. All facts relating to the transfer should be stated, including the motive therefor, the decedent's state of health, and his anticipation of death. The presumption of taxability may be rebutted by proof that the transfer was not induced by bodily or mental conditions leading the grantor to make a disposition of property testamentary in its nature. The fact that a gift was made as an advancement, to be taken into account upon the final distribution of the decedent's estate, is not enough, standing alone, to establish taxability: but it is a circumstance to be considered in determining whether the transfer was made in contemplation of death. (Reg. 37, Art. 23.)

The expression, "in contemplation of death," was held in the United States Circuit Court of Appeals[25] not to mean "on the one hand the general expectancy of death which is entertained by all persons, nor, on the other, is the meaning of the term necessarily limited to an expectancy of immediate death or dying conditions. Nor is it necessary, in order to constitute a transfer in contemplation of death, that the conveyance or transfer be made while death is imminent, or immediately impending by reason of ill health, disease, injury or like physical condition. But a transfer may be said to be made in contemplation of death if the expectancy or anticipation of death in either the immediate or reasonably near future is the moving cause of the transfer."

Generally speaking, the only argument in support of the contention that transfers within two years were not in contemplation of death, that can be urged with a measurable promise of success, arises where a sequence of events shows that the decedent, having had an eminently satisfactory business career, decides gradually to relinquish an active control of his interest and to enjoy the remainder of his life in well-earned ease. In such a case, the decedent is not contemplating death but rather a new lease of enjoyable life. The material factor then is the ultimate cause of death. Should it be that

[25] *Shwab v. Doyle*, 269 Fed. 321.

the state of decedent's health at the time the transfer was effected showed symptoms of the disease or ailment which was the ultimate cause of death, there is very little likelihood that any proof, however strong in circumstantial evidence, would enable the executor to prove that the property transferred was not in contemplation of death within the meaning of the law. The last hope would center in affidavits from reputable doctors to the effect that although such symptoms must have existed, decedent might be quite ignorant of their fatal significance—could such conceivably be the case. A widow, one year before death, conveyed by means of an absolute transfer a considerable amount of personal property. She died of apoplexy primarily resulting from hardening of the arteries. Held, the trust was created in contemplation of death.[26]

The ultimate disposition of a transfer effected less than two years before death depends entirely upon the available evidence and arguments showing the intention of the decedent. It is important that all of the evidence be assembled in the brief, which should be filed in support of the claim. Due regard should be given to the contingencies discussed in the following regulations:

REGULATIONS. A transfer is taxable where the grantor reserves to himself during life the income of the property transferred. In such a case the transfer of the principal takes effect in possession and enjoyment after the death of the grantor, and the value of the entire property should be included in the gross estate. Where the grantor reserves a proportionate part of the income, only a corresponding proportion of the property should be included in the gross estate, unless the transfer was made in contemplation of death. If, for example, he reserves one-half of the income, the value of one-half of the property transferred should be included in the gross estate. If he reserves an annuity, so much of the property as is necessary to produce the annuity should be included in the gross estate. Where the property does not produce income, its value as of the date of the decedent's death should be ascertained, and so much of this sum as is necessary to produce the annuity should be included in the gross estate. A transfer is taxable in accordance with these principles whether the grantor makes a reservation of the annuity out of the

[26] *Shwab v. Doyle*, 269 Fed. 321.

property conveyed, or exacts from the grantee an agreement to pay the annuity. A gift of the principal of a trust fund which takes effect at or after the decedent's death is taxable, although the income during the decedent's life is payable to some one other than himself. Example: The decedent transfers property to his son, the latter agreeing to pay the income to his mother during the decedent's life. The transfer to the son is taxable. (Reg. 37, Art. 24.)

Property held in trust under any instrument in which the grantor has reserved a power of revocation, or any power which has that effect, constitutes a part of the gross estate of such grantor for the purposes of this tax. For example, where a father places property in trust for the present benefit of his son, but reserves power to revoke the trust at any time during his life, the value of the entire property transferred should be included in the gross estate. (Reg. 37, Art. 25.)

Valuation of property transferred.—The rules of valuation already dealt with apply to property included under the caption of transfers. The value at the time of decedent's death includes only the original property transferred; any additions or betterments effected by the transferee, or portions of trust not originally contributed *or owned* by the decedent are excluded from inclusion in the gross estate.

Regulation. The property to be valued is the interest owned and transferred by the decedent; but the value of such property must be ascertained as of the date of the decedent's death. Where the transferee makes additions to the property, or betterments, the value of the additions or betterments at the time of death are not to be included. For example, a father makes a transfer to a son, in contemplation of death, of unimproved real estate valued at $20,000. The son erects buildings on the land at a cost of $10,000. The amount to be included in the gross estate of the father is the value of the entire property at the time of his death less the value of the buildings on that date. (Reg. 37, Art. 26.)

Property held jointly.—The following section of the 1921 law is considerably enlarged as compared with the same section in the 1918 law. In the latter any property which at any time had been in the possession of the decedent was to be included in the gross estate. The new provision allowing for the inclusion of what may have been acquired from the de-

cedent for a fair consideration, or in any case up to the amount of such consideration, removes an obvious hardship to the taxpayer which resulted under the arbitrary provision of the 1918 law. Gifts or bequests common to both spouses, also now for the first time included in this section, are placed on an equitable basis by law.

LAW. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated. . . . .**

(d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than a fair consideration in money or money's worth: *Provided,* **That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than a fair consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person:** *Provided further,* **That where any property has been acquired by gift, bequest, devise, or inheritance, as a tenancy in the entirety by the decedent and spouse, or where so acquired by the decedent and any other person as joint tenants and their interests are not otherwise specified or fixed by law, than to the extent of one-half of the value thereof; . . . .**[27]

REGULATION. The statute provides for the taxation of interests held jointly, or as tenants in the entirety, by the decedent and any other person or persons. This class of property includes all interests, whether in real or personal property, in which the survivor takes the entire property by right of survivorship, and it consequently does not form part of the decedent's estate for purposes of administration. It does not include interests held as tenants in common, where the interest of each tenant passes to his estate, free from any right of survivorship.

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[27] **[Former Procedure]** 1918 LAW. Section 402. . . . . (d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have belonged to the decedent; . . . .

The following are examples of this class of property: Real estate held jointly; real estate held by husband and wife (known as an estate in the entirety); money deposited in a bank or trust company in the joint names of the decedent and another and payable to either or the survivor; joint trading accounts with brokers; stocks and bonds held in the joint names of several owners. (Reg. 37, Art. 27.)

The regulations which govern the corresponding section of the 1918 law[28] interpreted that section in accord with what is now included in the law itself.

The expression "originally belonged" has been interpreted (T. D. 3225) as referring, not to the time of death, but to the time a joint interest was created. The act does not become retroactive because it measures a transfer tax on property which decedent has given away in his lifetime. In other words, the passing of property has, generally speaking, to be taxed under the estate tax law sooner or later, and the establishment of trusts or joint interests does not automatically release property of the decedent therein included from the application of the law. A surviving tenant's original half interest in a joint tenancy created prior to the enactment of the statute has been held to form part of the decedent's gross estate.[29]

Property passing under power of appointment.—The intention of the law is to reach all the property which a decedent had enjoyed during his lifetime. This includes not only such as he owned but also property of which he had merely the right to direct the disposition by his will or by a deed.

LAW. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—**

(e) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession

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[28] Reg. 37, 1918, Arts. 28 and 29.

[29] *McElligott v. Kissam et al.*, U. S. Circuit Court of Appeals, Second Circuit, June 30, 1921, Advance Opinions, 275 Fed. 545.

or enjoyment at or after, his death, except in case of a bona fide sale for a fair consideration in money or money's worth; . . . .

The provision made in this section, which is the same in the 1918 law, was included in that law in order specifically to embrace property transferred by a power of appointment. Section 202 (c) of the Revenue Act of 1916 served as a general provision which was intended to include such property in its provisions. This intent was more or less obscure. The 1916 law relied upon the rule generally followed, that equity will regard the property appointed under a power of appointment, either by deed or will, as part of the assets of the appointor. Nevertheless, it was held that, "The Revenue Act of 1916 did not impose an estate tax upon property passing under a testamentary execution of a general power of appointment."[30] Hence the direct provision in the statutes subsequent to 1916.

By "a general power of appointment" is meant the power which is often given by a will to the life beneficiary of a trust fund to name or appoint the persons who shall receive the principal after his life estate shall have terminated. Such principal, under the estate tax law, is taxable as the property of the life beneficiary at his death if he exercises the power of appointment by his will or by a deed made in contemplation of death or intended to take effect at or after his death (except in the case of a bona fide sale for a fair consideration). The principal is therefore to be included in the appointor's gross estate.

Regulation. As a general rule, property passing under a general power of appointment must be included in the gross estate of the person exercising the power (known as the donee, or appointor) where the power is exercised by will, or by deed executed in contemplation of death, or intended to take effect at or after death. This general rule applies wherever the decedent died after September 8, 1916, although the power was created prior to that date. In certain cases, however, the transfer is taxable under the Revenue Act of 1918 when it would not be taxable under the Revenue Act of 1916 (See Art. 31).

Only property passing under a *general* power should be included.

[30] *U. S. v. Field,* 255 U. S. 257, 65 L. Ed. 355, 41 Sup. Ct. 256, October Term, 1920.

A general power is one to appoint to any person or persons in the discretion of the donee. Where the donee is required to appoint to a specified person or class of persons, the property should not be included in his gross estate. Property appointed under a general power should be included in the estate of the appointor, although the persons to whom the appointment was made would have taken the property had the power not been exercised. A copy of the instrument granting the power should be filed with Form 706 in all cases in order that the Bureau may determine whether the power is general or special.

Example: The income of property is left to a person for life, with the right to name in his will the person who shall receive it upon his death. He exercises this power in his will. Upon his death, if occurring after September 8, 1916, the property so appointed should be included in his gross estate. (Reg. 37, Art. 30.)

REGULATION. The Revenue Act of 1918 taxes all transfers effected by the exercise of a general power of appointment, provided the exercise was by will, or by deed made in contemplation of death, or intended to take effect at or after death. It follows that all transfers of this character, where the decedent died after February 24, 1919, are taxable, and the property must be included in the gross estate.

Where the decedent died between September 8, 1916, and February 25, 1919, the taxability of the transfer depends upon whether the property was subject to the claims of the creditors of the appointor, in preference to the person or persons in whose favor the power was exercised. The general rule is, that the property is so subject; and it should consequently be included in the gross estate unless this rule has been abrogated in the State whose laws determine the nature and effect of the transfer. All such transfers should be disclosed to the Bureau in order that it may pass upon the question of taxability. (Reg. 37, Art. 31.)

The right to tax property passing under a power of appointment does not solely depend on whether or not the property is subject to the claims of the creditors of the appointor. Such property to be subject to the estate tax involved must also be property subject to distribution as a part of the decedent's estate. "It is the general rule of the common law subject to certain exceptions, that the appointee of an estate takes from the original donor and not from the donee of the power."[31]

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[31] *Ebersole v. McGrath,* 271 Fed. 995.

Insurance.—It is recognized that a reasonable amount of life insurance should pass to beneficiaries free from tax. The amount exempted in the 1921 law is $40,000, just as under the 1918 law.

LAW. Section 402. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . . .

(f) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.

REGULATION. The statute provides for the inclusion in the gross estate of certain forms of insurance taken out by the decedent upon his own life. Two kinds of insurance are taxable: (*a*) all insurance payable to the estate; (*b*) insurance payable to individual beneficiaries to the extent that it exceeds $40,000. The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system. Insurance is deemed to be taken out by the decedent in all cases where he pays the premiums, either directly or indirectly, whether or not he makes the application. On the other hand, the insurance should not be included in the gross estate, even though the application is made by the decedent, where the premiums are actually paid by some other person or corporation, and not out of funds belonging to, or advanced by, the decedent. Where the decedent takes out insurance in favor of another person or corporation, as collateral security for a loan or another accommodation, and the decedent, either directly or indirectly, pays the premiums thereon, the insurance must be considered in determining whether there is an excess over $40,000. Where the decedent assigns a policy, and retains no interest therein, and thereafter pays no part of the premiums, the insurance will not be considered in determining whether there is such a taxable excess. (Reg. 37, Art. 32.)

When premiums are paid by other persons and the executor is not required to include the proceeds of the insurance in the gross estate of the decedent, care must be exercised to see that such payments were not constructive payments by the deceased; as, for instance, where premiums are paid by a corporation on behalf of an official as part of the latter's compensation for services, the benefit of such insurance accruing to the

official's heirs or assigns. This benefit would form part of the gross estate in so far as it, or any portion of it, was in excess of $40,000. All insurance coming under the provisions of this section must be included in detail in schedule C of form 706. The amounts of insurance payable to beneficiaries, other than the executor, not in excess of $40,000, are not extended. The balance, if any, is extended and so comprised in the total gross estate reported in this schedule. The inclusion of insurance effected as security for indebtedness is obviously correct, the indebtedness itself being an offset for inclusion in deductions from gross estate in schedule I.

The constitutionality of taxing the proceeds from life insurance policies payable to beneficiaries other than the estates of decedents is open to question. The estate tax is "imposed upon the transfer of the net estate of every decedent."[32] The estate of the decedent consists of all property of which the decedent dies seized and possessed, and which can be devised by him; or, if he dies intestate, is distributed according to the statutes of descent and distribution as provided by law. The property is of such a nature as to be liable for his debts. The proceeds of life insurance which do not go to a decedent's estate never formed any part of the decedent's estate, nor were they liable for his debts. Where endorsed to a third party, no reversionary interest or equity entered into the value of the decedent's estate prior to his death.

In this connection the following dissenting opinion of Mr. Justice Holmes is pertinent:

> Decision. . . . . If the succession has fully vested, or has passed beyond dependence upon the continuing of the state's permission or grant, an attempt to levy a tax under the power to regulate succession would be an attempt to appropriate property in a way which the 14th Amendment has been construed to forbid.[33]

A test as to the taxability of this form of insurance is

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[32] Section 401.
[33] *Chanler v. Kelsey,* 205 U. S. 466, 479, 51 L. Ed. 882, 27 Sup. Ct. 550.

furnished in a case before the United States District Court of Maryland.[34] The testator, two months before his death, had caused three insurance policies to be made payable to his son and daughter. He reserved no interest to himself nor to his personal representatives. The transfers were made without consideration and within two years of his death. The court decided:

Decision. Under the circumstances, I do not feel justified in holding that the three policies, which were absolutely assigned, were within the statutory meaning of the phrase "transferred in contemplation of death."

These three policies, therefore, did not remain a part of the decedent's estate, so as to be subject to the estate tax.

The above decision is conclusive in its expression. If, even within two months of death, these insurance policies were not considered as "made in contemplation of death" within the meaning of the statute, it would seem that any absolute transfer effected in such a manner could be reasonably held to be without the power of the estate tax law.

Regulations. The provision requiring the inclusion in the gross estate of all insurance receivable by the executor, without any deduction, applies to policies made payable to the decedent's estate or his executor or administrator, and all insurance, regardless of the manner of execution, which is in fact receivable by the estate, or which must be used to pay charges against the estate or the expenses of administration. This provision includes insurance taken out to provide funds to meet the estate tax, state inheritance taxes, or any other legal charge upon the estate. The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of the charge. (Reg. 37, Art. 33.)

The estate is entitled to only one exemption of $40,000 upon insurance payable to beneficiaries other than the executor. For example, if the decedent left life insurance payable to three persons in amounts of $10,000, $40,000 and $50,000 (total $100,000), the amount of $60,000 should be returned for taxation, which is the excess of the sum of the three policies over the exempted amount. The word

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[34] *Gaither v. Miles,* 268 Fed. 692.

"beneficiary," as used in reference to the $40,000 exemption, means a person entitled to the actual enjoyment of the insurance money. (Reg. 37, Art. 34.)

Insurance receivable by the executor must be included in the gross estate of all decedents who died after September 8, 1916. Insurance payable to beneficiaries other than the executor, however, need not be included in the gross estate of decedents who died before February 25, 1919, the effective date of the Revenue Act of 1918, unless the insurance was originally payable to the estate, and was transferred by the decedent to specific beneficiaries in contemplation of death." (Reg. 37, Art. 35.)

The amount to be returned in the case of any policy is the amount actually receivable by the executor or beneficiary. In cases where the proceeds of a policy are made payable to the beneficiary in the form of an annuity for life or for a term of years, the present worth of the annuity at the time of death should be included in the gross estate. For the method of computing the value of such an annuity, see Article 20.[35] Where the insurance contract gives an option to receive a fixed sum of money in lieu of an annuity, this sum, if accepted, represents the value of the insurance for the purpose of the tax. If such sum is not accepted the value of the annuity is to be included in the gross estate. Where there is more than one option, and none of them is convertible, the value of the insurance should be determined in accordance with the option actually exercised. (Reg. 37, Art. 36.)

The foregoing regulations merely explain the principle under which the proceeds of life insurance are included in the gross estate.

Deductions from Gross Estate

Deductions allowed resident estates.—Having computed the amount of the gross estate, the next step is to ascertain the allowable deductions.

LAW. Section 403. **That for the purpose of the tax the value of the net estate shall be determined—**

(a) In the case of a resident, by deducting from the value of the gross estate—

(1) Such amounts for funeral expenses, administration expenses, claims against the estate, unpaid mortgages upon, or any indebtedness in respect to, property (except, in the case of a resident decedent,

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[35] See page 1453.

where such property is not situated in the United States), losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated for by insurance or otherwise, and such amounts reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent, as are allowed by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered, but not including any income taxes upon income received after the death of the decedent, or any estate, succession, legacy, or inheritance taxes.

Regulations. In the case of the estates of residents, the deductions are made from the value of the entire gross estate, wherever situated. The deductions specified in the above provisions, contained in the Revenue Act of 1918, are proper in all cases where the decedent died on or after February 25, 1919. Where the decedent died prior to February 25, 1919, the case is governed by the provisions of the Revenue Act of 1916, which permits the following deductions:

(1) Funeral expenses.
(2) Administration expenses.
(3) Claims against the estate.
(4) Unpaid mortgages.
(5) Losses from casualty or theft.
(6) Support of decedent's dependents.
(7) Other charges against the estate.
(8) Specific exemption of $50,000.
(9) In the case of decedents dying after December 31, 1917, public, religious, charitable, scientific, literary, and educational bequests.

The provision in the Revenue Act of 1916 for the deduction of "such other charges" than those previously specified as may be allowed by the laws of the jurisdiction is omitted in the Revenue Act of 1918. Consequently, in the case of estates of all persons dying after February 24, 1919, the executor, in order to obtain a deduction, must bring the item within one of the classes specifically described. (Reg. 37, Art. 37.)

In order to be deductible, the item must be of the character described in the statute; and it must also be one the payment of which out of the estate is allowed by the law of the jurisdiction administering it. Where the item is not one of those described, it is not deductible merely because payment is allowed by the local law. On the other hand, no item is deductible unless its payment is so allowed. It must appear in every case either that payment of the item has been made, or that such payment is clearly contemplated. Where the amount which may be expended for the particular purpose is limited by the local law, no deduction in excess of such limitation is permissible. Where the local courts have approved the expenditure it

will ordinarily be allowed for deduction. (See Art. 39.) Where the disbursement has not been made, the item may be entered for deduction where the amount is certain, and it appears satisfactorily that it will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. Where an uncertain or contingent liability, not allowed as a deduction, becomes fixed, and payment is made, the remedy is a claim for a refund of the excess tax. (Reg. 37, Art. 38.)

Effect of court decree on deductibility.—

Regulation. The decision of a local court as to the amount of a claim or administration expense will ordinarily be accepted where the court passes upon the fact upon which deductibility depends. Where the court does not pass upon such fact its decree will, of course, not be followed. For example, where the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing that the claim is valid and the amount of it. Where, however, a legacy is left to an executor in lieu of commissions, the allowance of the legacy does not establish that the executor's claim for commissions is equal to the amount bequeathed, and that this amount is consequently deductible. (See Art. 42.) Nor will the decree necessarily be accepted even where it purports to decide the fact upon which deductibility depends. It must appear that the court actually passed upon the merits of the case. This will be presumed in all cases where there is an active and genuine contest. Where the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by proof to the contrary. Where the decree was rendered by consent, it will be accepted, provided the consent was a *bona fide* recognition of the validity of the claim—not a mere cloak for a gift—and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character, and was so accepted, where it is made by all parties having an interest adverse to the claim, when all aspects of the matter, including its effect upon taxation, are considered. The decree will not be accepted where it appears to be at variance with the law of the State; as, for example, if an allowance is made to an executor in excess of the rate prescribed by statute. (Reg. 37, Art. 39.)

Funeral expenses.—

Regulation. An executor may deduct such amounts for funeral expenses as are actually expended by him, provided expenditures of this nature are a liability of the estate under the laws of the local jurisdiction. A reasonable expenditure by the executor for a tombstone, monument or mausoleum, or for a burial lot, either for the de-

cedent or his family, may be deducted under this heading, provided such an expenditure is made a charge upon the estate by the local law. Included in funeral expenses is the transportation of the person bringing the body to the place of burial. (Reg. 37, Art. 40.)

Administration expenses.—

Regulation. The amounts deductible from the gross estate as "administration expenses" are such expenses as are actually and necessarily incurred in the administration of the estate; that is, in the collection of assets, payment of debts, and distribution among the persons entitled. The expenses contemplated in the law are such only as attend the settlement of an estate by the legal representative preliminary to the transfer of the property to individual beneficiaries or to a trustee, whether such trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; (3) miscellaneous expenses. Each of these classes is considered separately. (See Arts 42 to 44.) (Reg. 37, Art. 41.)

Executor's commissions.—

Regulation. No amount may be deducted as executor's commissions in excess of that actually paid or to be paid, and in no case in excess of the amount allowable by the law of the jurisdiction wherein the estate is being administered. If at the time of filing the return the commissions of the executor have not been allowed or awarded by the court or tribunal having jurisdiction in the premises, the commissions may nevertheless be entered on the return and claimed as a deduction, subject to future allowance or disallowance by the Commissioner, provided: (1) That the amount entered and claimed is within the amount allowable by the laws of the jurisdiction wherein the estate is being administered; (2) that such amount is in accordance with the usually accepted practice in such cases within said jurisdiction; and (3) that it may reasonably be expected that the said amount will be paid within one year and 180 days after the decedent's death. Except in those cases in which the commissions have been both awarded and paid, the Commissioner may at any time require the executor to furnish satisfactory evidence of his right to take or claim the deduction. Whenever it shall appear to the Commissioner that the commissions claimed but not awarded, whether paid or unpaid, exceed the amount allowed by law or exceed the amount usually allowed within the commonly accepted practice of the jurisdiction wherein the estate is being administered, or where in any case the Commissioner finds after the lapse of 1 year and 180

days after the decedent's death that the commissions have not been paid, the deduction will be disallowed, subject to the right of the executor thereafter in a proper case to file a claim for abatement or refund as he may be advised, when the commissions shall have been actually awarded and paid. Where the executor does not intend to make any charge upon the estate for his services, no deduction may be claimed.

No deduction may be made for trustees' commissions, and an executor who acts as trustee is not entitled to deduct the commission he receives for his services in the latter capacity. The executor's duties are complete when he has turned over the estate or the proceeds to the persons entitled thereto. Such persons may be beneficiaries entitled to receive the property in their own right, or trustees entitled to receive it in the right of their cestuis que trustent. The services of the trustees are distinct from, and additional to, the ordinary duties of an executor in the settlement of estates; and commissions for such trustees' services do not constitute an expense of administration.

Where a bequest is made to an executor in lieu of commissions it may be deducted as an administration expense only to an amount thereof not in excess of the amount allowable as commissions by the law of the jurisdiction wherein the estate is being administered. If the legacy is in excess of such allowable commissions, the excess may not be deducted. (Reg. 37, Art. 42.)

Attorney's fees.—

Regulation. No amount may be deducted in any case as attorney's fees in excess of that actually paid or to be paid. If at the time of filing the return the attorney's fees have not been allowed or awarded by the court or tribunal having jurisdiction in the premises, they may nevertheless be entered on the return and claimed as a deduction, subject to future allowance or disallowance by the Commissioner, provided: (1) That the amount so entered and claimed is reasonable in consideration of the services performed and the value of the estate; and (2) that it may reasonably be expected that such amount will be paid within 1 year and 180 days after the decedent's death. Except in those cases in which the attorney's fees have been both awarded and paid, the Commissioner may at any time require the executor to furnish satisfactory evidence of his right to take or claim this deduction. Whenever it shall appear to the Commissioner that the fees claimed were not awarded, and whether paid or unpaid, exceed a reasonable amount in the discretion of the Commissioner, or where in any case the Commissioner finds after the lapse of 1 year and 180 days after the decedent's death that the fees have not been paid, the deduction will be disallowed, subject to the right of the executor thereafter, in a proper case to file a claim for abatement or refund as he may be advised, when the fees have actually been awarded and

paid. The cost of litigation instituted by the beneficiaries as to the amount of their respective interests may not be deducted, since expenses of this character are properly charges against the beneficiaries personally, rather than against the general estate. (Reg. 37, Art. 43.)

Miscellaneous administration expenses.—

Regulation. This item includes expenses incident to court proceedings, or the administration of the estate, such as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in distributing the estate are deductible. This includes the cost of storing or maintaining property of the estate, where it is impossible to effect immediate distribution to the beneficiaries. Expenses for preserving and caring for the property may be deducted, but do not include additions or improvements; nor will such expenses be allowed for a longer period than the executor is required to retain the property. A brokerage fee for selling property of the estate is deductible where the sale is necessary in order to pay the decedent's debts, or the expenses of administration, or to effect distribution. Other expenses attending the sale are deductible, such as the fees of an auctioneer, where it is reasonably necessary to employ one. (Reg. 37, Art. 44.)

Claims against the estate.—

Regulation. The amounts that may be deducted under this heading are such only as represent personal obligations of the decedent existing at the time of his death, whether then matured or not. Obligations contracted by the executor are not deductible. Only such claims as are actually enforceable against the estate may be deducted. (Reg. 37, Art. 45.)

Taxes.—

Regulation. Taxes upon real property should be accrued to the date of death. This is done by ascertaining the time between the first day of the taxable period wherein the death occurs and the date of death, and computing the proportion of the entire tax which this period bears to the entire taxable period. Such proportion of the tax has accrued upon the date of death, and is deductible.

Taxes upon personal property are either wholly deductible, or are not deductible at all, depending upon whether the tax did, or did not, become the personal obligation of the taxpayer in his lifetime. If the tax became his personal obligation during his life, the whole amount is deductible as a claim against his estate. If it did not become such personal obligation in his lifetime, no part of it is deductible. The question when the tax became the personal obligation of the taxpayer depends upon the law of the jurisdiction where the

decedent was domiciled at the time of his death. Prima facie, the date when the tax became the personal obligation of the taxpayer is the date when the assessment was laid.

In the case of federal taxes upon income, the tax upon income received or accrued during the decedent's lifetime constitutes the personal obligation of the decedent, and is deductible. Taxes upon income received after the decedent's death are not deductible. No estate, succession, legacy, or inheritance tax is deductible. (Reg. 37, Art. 46.)

Unpaid mortgages.—

Regulation. The full amount of unpaid mortgages on property included in the gross estate should be deducted under this heading, including interest which had accrued at the time of death, whether payable at that time or not. Interest should be computed upon the basis of 365 days to the year. The full value of the real estate, without any deduction for mortgages, must be returned as part of the gross estate. As real property situated outside of the United States is not part of the gross estate, the amount of mortgages upon such property should be deducted only where the decedent was personally liable for the mortgage debt. (Reg. 37, Art. 47.)

Losses from casualty or theft.—

Regulation. There may be deducted under this heading losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated by insurance or otherwise. If the loss is partly compensated, the excess of the loss over such compensation may be deducted. Losses not of the nature described are not deductible. Losses sustained by reason of depreciation in the value of the assets of the estate subsequent to the decedent's death are not deductible. The term "casualty" includes only losses of a fortuitous and unusual character, such as result from violence, or from a disaster which could not be foreseen or prevented by the exercise of reasonable care. Losses due to the death of animals from disease are deductible. In order to be deductible a loss must occur during the settlement of the estate. Where property has been delivered to the beneficiary, settlement has been effected, and no deduction may be had for loss of the property. (Reg. 37, Art. 48.)

Support of dependents.—

Regulation. The support during the settlement of the estate of dependents of the decedent should be deducted, but pursuant to the following rules:

(1) In order to be deductible, the allowance must be authorized by the laws of the jurisdiction in which the etsate is being administered, and not in excess of what is reasonably required.

(2) The allowance for which deduction may be made is limited to support during the settlement of the estate. Any allowance for a more extended period is not deductible.

(3) There must be an actual disbursement from the estate to the dependents, but after payment has been made the right of deduction is not affected by the fact that the dependents do not expend the entire amount for their support during the settlement of the estate. (Reg. 37, Art. 49.)

The governing factor in determining the deductibility of expenses is their allowance as such under local statutes. Careful study of such statutes is therefore necessary, since under some jurisdictions a deduction for the support of dependents is not permitted. Nevertheless, expenses, to be deductible from the gross estate, must come distinctly under some one of the descriptions enumerated in section 403 (a) of the act. Particular attention is drawn to the treatment of the executor's commission where a specific sum has been willed by the decedent for this remuneration. Any such amount in excess of the total commission permitted by the local court is disallowed.

The exclusion of mortgages on property of a resident decedent which is situated outside the United States is a new provision. Under the 1918 regulations, mortgages on property owned outside the United States were deductible when the decedent was personally liable for the mortgage debt.[36] The latter would seem to be the more equitable treatment.

Where the indebtedness of the decedent includes notes payable, care should be taken to ascertain whether such notes are secured by collateral. The value of such collateral would, of course, have to be included in the gross estate.

In connection with the deductibility of estate, succession, legacy or inheritance taxes from the gross estate, despite the fact that estate taxes are included in those not deductible under the law,[37] the government contended, in a court case,

[36] Reg. 37, 1918, Art. 47.
[37] Sec. 403 (a-1).

that estate taxes were deductible because levied against the estate itself, but that "legacy" taxes are not deductible, because levied against the legatee.[38] In this particular case the decision was that the Massachusetts tax should have been deducted before the estate tax was computed. The court also stated it to be "unjust to hold that under this Federal Statute (Revenue Act of 1916) the State tax was deductible in one state and not deductible in another, upon a subtle legalism without practical value." On the other hand, a contrary opinion has been handed down by the Supreme Court of the United States:[39] "'Charges against the estate' as pointed out by the Court below, are only charges that affect the estate as a whole, and therefore do not include taxes on the right of individual beneficiaries. This reasoning excludes not only the New York succession tax, but those paid to other states, which can stand no better than that paid in New York." And again, in the United States District Court, Northern District, New York,[40] it was held that the New York transfer tax was a proper deduction to be made in the tax due the United States. As to the Pennsylvania collateral inheritance tax, the court decided [41] that it is an estate tax, not a legacy tax, and that as such it is levied upon and made a charge against the estate. For this reason the court held that the tax was deductible from the gross estate before the imposition of the federal estate tax.

With these conflicting decisions given, it can only be said that the question of deductibility of state estate or inheritance taxes is entirely dependent upon the exact nature of the tax imposed by a particular state.

Deduction for property previously taxed.—

LAW. Section 403. **That for the purpose of the tax the value of the net estate shall be determined—**

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[38] *Thayer et al. v. Malley*, U. S. District Court, Mass., March 28, 1921 (case not reported).

[39] *N. Y. Trust Co. et al. v. Eisner*, U. S. Sup. Ct., October term, 1920. Advance Opinions 620.

[40] *[illegible] et al. v. [illegible]*, 268 Fed. 753.

[41] *Northern Trust Co. v. Lederer*, 262 Fed. 52; certiorari denied, 252 U. S. 487, 64 L. Ed. 1025, 40 Sup. Ct. 483.

(a) In the case of a resident, by deducting from the value of the gross estate— . . . .

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided*, That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in the decedent's gross estate and not deducted under paragraphs (1) or (3) of subdivision (a) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916; . . . .

While in general accord with the corresponding section of the 1918 law,[42] this section also includes some provisions previously covered merely by regulation. The intent is perfectly clear, in that where an estate tax has been paid on the transfer of any portion of the decedent's estate within five years prior to the date of death, no further federal tax need be paid in respect of that particular property.[43]

Only the value accepted by the Commissioner in the return of the prior decedent may be deducted from the gross estate under this section. If the actual value at date of decedent's death exceeds the original value the excess must be included in the gross estate.

Property owned by a resident or non-resident decedent which formed part of the estate of anyone dying after September 8, 1916, and upon which an estate tax had been paid, may be deducted from the gross estate. The rules for such deduction may be summarized as follows:

1. The two deaths must have occurred within five years of each other.

[42] Reg. 37, 1918, Art. 50.

[43] As to the effect of the change of the effective date on refunds of tax, see page 1513.

2. The first decedent must have died after September 8, 1916, and the second after November 23, 1921.
3. Tax must have been paid on the first decedent's property.
4. The value exempt from taxation in the case of the last decedent is the value at which such property was included in the gross estate of the prior decedent.
5. The property shall be situated in the United States at the time of the last decedent's death.

The third condition above paves the way for possibility of an injustice in certain cases. It is specifically stated that the filing of a return is not a sufficient cause for deduction [44] but that the tax itself must have been paid. The inevitable construction to be placed on this condition is that the net estate of the first decedent must have exceeded the $50,000 specific exemption; otherwise there would have been no taxable estate and, consequently, no tax paid. Any benefit accruing to the estate of the last decedent, under these circumstances, is entirely dependent on the fact as to whether or not the gross estate of the prior decedent exceeded $50,000.

If the gross estate of the prior decedent exceeded $50,000, then bequests to the second decedent will be deductible from the latter's gross estate. This is true, in spite of the fact that the estate of the prior decedent (if a resident) was only subject to tax on the amount in excess of $50,000.

Where the gross estate of the prior decedent was less than $50,000, no tax was payable (by a resident), and therefore the estate of the second decedent will be unable to deduct any bequests received from the prior decedent.

To illustrate:

(1) Assume A (a resident) had a gross estate of	$100,000
Deduct: Specific exemption	50,000
Tax paid by A's estate on	$ 50,000

[44] Reg. 37, 1918, Art. 62.

B (a resident) has a personal estate excluding payment from A of		$ 40,000
Bequest from A		100,000
Gross estate of B		$140,000
Deduct: A's bequest	$100,000	
Specific exemption	50,000	150,000
Excess of deductions		*$ 10,000*

No tax due on B's estate.

The Treasury receives in total from the estates of A and B tax on	$ 50,000
(2) Assume A (a resident) had a gross estate of	$ 40,000

No tax is payable by the estate of A.

B (a resident) has a personal estate excluding bequest from A of	$100,000
Bequest from A	40,000
Gross estate of B	$140,000
Only the specific exemption can be deducted	50,000
Total paid by A's estate on	$ 90,000
The Treasury receives in total from the estates of A and B tax on	$ 90,000

It follows that the discrimination referred to above results in the collection by the Treasury of a tax on $40,000 more in the second case than in the first although the total personal estates (excluding the transfer) of A and B are identical in the two examples, namely, $140,000.

The discrimination is unfair. The Treasury should permit in the second case the deduction of $40,000 from the estate of B, which is the intention of Congress.

Deduction for property acquired in exchange.—

Regulations. The deduction for substituted property is limited to property acquired in exchange for the identical property received from the estate of the prior decedent. Where there is a subsequent exchange, the right to deduction is lost. Where, however, property is sold, and the proceeds immediately invested in other property, the property purchased is deemed to be taken in exchange, and its value is deductible.

In the case of an exchange the executor must describe and identify fully both the property originally received from the prior estate and the property acquired in exchange therefor. He must also state the

date and nature of the transaction by which the exchange was effected, the name and address of the transferee, and the consideration, if any, given or received by the decedent in addition to the property received from the prior estate. If the exchange was made by written instrument of public record, a precise reference must be made to the record containing the instrument, and if by instrument not of record a copy of the instrument must be supplied. If there was no written instrument, an affidavit as to the facts of the exchange by one or more persons having personal knowledge of the matter must be furnished.

If at the time of exchange the decedent gave a consideration in addition to the property received from the prior estate, and acquired property of greater value than the property so received, there may be deducted the proportion of the value of the property received in exchange which the value of the original property bears thereto. (Reg. 37, Art. 52.)

If the property originally received from the prior estate is included in the decedent's gross estate, the executor must describe it fully, and prove its identity with the property received from the prior estate. The value to be deducted is the value at the time of the second decedent's death. (Reg. 37, Art. 51.)

Since the amount of property originally received under the conditions mentioned will have been included (on schedule G of form 706) at its value at the time of decedent's death, the deduction made (on schedule K of form 706) will be at the same figure.

Deduction for charitable and similar bequests.[45]—

Law. Section 403. That for the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a resident, by deducting from the value of the gross estate— . . . .

(3) The amount of all bequests, legacies, devises, or transfers, except bona fide sales for a fair consideration in money or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any corporation organized and operated exclusively

[45] [Former Procedure] Provision for the deduction of charitable and similar bequests was first instituted in the 1918 law. That law provided for deductions similar to those which are allowed under the 1921 law. Prior laws made no allusion to this form of deduction from gross estate.

for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious, charitable, scientific, literary, or educational purposes. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917; . . . .

Regulations. Bequests to religious, charitable, scientific, literary, or educational corporations are deductible only if the corporation is organized or operated exclusively for one of the purposes specified (see Art. 54). Similarly, in the case of a trust, the trust must be exclusively for such purposes. It does not prevent deduction, however, that the property placed in trust is also subject to another trust for a private purpose. Thus, where money or property is placed in trust to pay the income to an individual during life, and then to pay or deliver the same to a charitable corporation, or apply the principal to a charitable purpose, the charitable bequest or devise forms the basis for a deduction. The amount of the deduction, in such case, is the value, at the date of the decedent's death, of the remainder interest in the money or property which is devised or bequeathed to charity. For the manner of determining the value of such remainder interest, see Article 20. Gifts made in the decedent's lifetime are deductible only if made in contemplation of death ,or intended to take effect at or after death, and the property is consequently included in the gross estate. Gifts made in satisfaction of a legacy are also deductible. The deduction is not limited in the case of the estates of residents to bequests to domestic corporations or to trustees for use within the United States. (Reg. 37, Art. 53.)

In order to be exempt the corporation or association must meet three tests: (1) it must be organized and operated for one or more of the specified purposes; (2) it must be organized and operated *exclusively* for such purposes; and (3) no part of its income must inure to the benefit of private stockholders or individuals.

(1) Charitable corporations include an association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by improving the efficient administration of justice. Educational corporations include an association whose sole purpose is the instruction of the public, even if it merely disseminates propaganda on a single question. Thus an association inculcating prohibition or protectionist principles is exempt. The same is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement

features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community, and whose amusement features are incidental to this purpose. Societies designed to encourage the performance of first-class orchestral music are not exempt, the purpose being merely to provide a high grade of entertainment. Scientific corporations include an association for the scientific study of law, to the end of improvement in its administration.

(2) Where a religious corporation owns a large quantity of farm land and works it, and also manufactures and sells clothing and other articles for profit, it is not operated exclusively for religious purposes and is not exempt, even though its property is held in common and its profits do not inure to the benefit of individual members of the society.

(3) It does not prevent exemption that private individuals, for whose benefit a charity is organized, received the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders. If, however, a corporation issues "voting shares," which entitle the holders upon the dissolution of the corporation to receive the proceeds of its property, including accumulated income, the right to exemption does not exist, even though the bylaws provide that the shareholders shall not receive any dividend or other return upon their shares. (Reg. 37, Art. 54.)

The foregoing regulations in most respects properly interpret the law. When the intention of the law is to exempt certain gifts from taxation, gifts falling reasonably within the exempt class should be tax-free. The regulations are too drastic in such cases as a religious corporation which operates a farm, a factory, a hotel, and a theatre, the profits, if any, from these varied operations being entirely devoted to the religious objects for which the corporation was formed. Surely it cannot be maintained that such bequests were other than for the specific furtherance of those religious objects. The test in such a case is the object of the pursuits followed, not the form which those pursuits may take. Should any of the profits inure to the stockholders (which it is expressly stated that they do not), then the exclusively religious purpose of the organization would cease and the bequest would automatically be deprived of any claim as a deductible item.

A decedent may bequeath a farm to a religious institution. The gift is tax-free. The institution is unable to sell the farm and operates it to the best advantage. Another decedent makes a money bequest to the same institution. If the farm has been neglected the second bequest is tax-free; if proper care has been taken of the farm the second bequest is not tax-free! It is impossible to read into the law any such *reductio ad absurdum.* Yet the regulations appear to so hold.

It is difficult to see for what reason contributions to community chests, funds, or foundations are not included in the deductions under this title. For income tax purposes [46] they are specifically enumerated among the deductions allowed to individuals. This is an invidious distinction as between the treatment of contributions donated by an individual himself and those donated by his executor in accord with his expressed desires before his death. The anomaly is further instanced by the fact that contributions by a living individual to the National Dry Federation are not allowable deductions from gross income, while a bequest to an association established for the purpose of inculcating prohibition principles is deductible from the gross estate under this section.[47]

In claiming the deduction for charitable and similar bequests, the executor is required to submit certain documentary evidence as indicated in the following article:

Regulations. In order to prove his right to this deduction the executor must submit:

(1) Certified copy of the will of the decedent or the instrument of gift in the case of a transfer of property in contemplation of death.

(2) A receipt, statement, or other documentary evidence to show the beneficiary's receipt of, or intention to accept, the legacy, devise, or gift.

(3) Affidavit of the executor stating whether any action has been instituted to contest the will, or whether, according to his information and belief, any such action is contemplated.

(4) Such other document or evidence as may be specified by the Bureau. (Reg. 37, Art. 55.)

[46] Title II, section 214 (a-11).

[47] Reg. 37, 1918, Art. 54.

Where the bequest, legacy, devise, or gife is dependent upon the performance of some act, or the happening of some event, in order to become effective, it is necessary that the performance of the act or the occurrence of the event shall have taken place before the deduction can be allowed. Where the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power. (Reg. 37, Art 56, as amended by T. D. 3241, dated November 1, 1921.)

The deduction may be claimed by the estates of all decedents dying after December 31, 1917. Where the tax has been paid without taking the deduction a claim for refund may be made, as provided by Article 110. (Reg. 37, Art. 57.)

Specific exemption.—The 1921 law makes no change in the specific exemption of $50,000 allowed in the case of resident estates. This exemption has been allowed in all laws from 1916.

Law. Section 403. **That for the purpose of the tax the value of the net estate shall be determined—**

(a) In the case of a resident, by deducting from the value of the gross estate— . . . .

(4) An exemption of $50,000; . . . .

Regulation. There may be deducted from the gross estate of all resident decedents a specific exemption of $50,000. No part of this exemption is allowed in the case of nonresident decedents. (See Art. 59.) If more than one return is made for purposes of the tax, the exemption may be taken only once. (Reg. 37, Art. 58.)

Method of determination of net estate of non-residents.—In computing the net estate of a non-resident which is subject to tax, there are two important differences from the procedure in the case of resident estates:

1. There is no especific exemption of $50,000.
2. Only the amount of the gross estate which is deemed to be situated in the United States is considered, and from this amount the statutory deductions (limited to 10 per cent of the gross estate [48]) are subtracted.

[48] Section 403 (b-1).

Status of certain property of non-resident estates.—

Law. Section 403. . . . . (b) . . . . (3) **For the purpose of this title stock in a domestic corporation owned and held by a nonresident decedent shall be deemed property within the United States, and any property of which the decedent has made a transfer or with respect to which he has created a trust, within the meaning of subdivision (c) of section 402,[49] shall be deemed to be situated in the United States, if so situated either at the time of the transfer or the creation of the trust, or at the time of the decedent's death.**

The amount receivable as insurance upon the life of a nonresident decedent, and any moneys deposited with any person carrying on the banking business, by or for a nonresident decedent who was not engaged in business in the United States at the time of his death, shall not, for the purpose of this title, be deemed property within the United States.

The exclusion of the proceeds of life insurance, or bank deposits, is an exemption granted to non-residents for the first time in this law. Heretofore, when the insurer was a domestic corporation, insurance receivable from such a source was deemed to be property within the United States, and, as such, subject to inclusion in the taxable gross estate. Neither of these exemptions apply to non-residents engaged in business in the United States.

Missionaries classed as residents.—

Law. Section 403. . . . . (b) . . . . (3) **Missionaries duly commissioned and serving under boards of foreign missions of the variour religious denominations in the United States, dying while in a foreign missionary service of such boards, shall not, by reason merely of their intention to permanently remain in such foreign service, be deemed nonresidents of the United States, but shall be presumed to be residents of the State, the District of Columbia, or the Territories of Alaska or Hawaii wherein they respectively resided at the time of their commission and their departure for such foreign service.**

The foregoing paragraph applying to missionaries and, in effect, placing them in the same plane, as far as deductions and exemptions are concerned, as residents, is a new and equitable feature of the 1921 law.

[49] A trust created in contemplation of death.

Deductions allowed non-resident estates.—

LAW. Section 403. That for the purpose of the tax the value of the net estate shall be determined— . . . .

(b) In the case of a nonresident, by deducting from the value of that part of his gross estate which at the time of his death is situated in the United States—

(1) That proportion of the deductions specified in paragraph (1) of subdivision (a) of this section[50] which the value of such part bears to the value of his entire gross estate, wherever situated, but in no case shall the amount so deducted exceed 10 per centum of the value of that part of his gross estate which at the time of his death is situated in the United States; . . . .

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided*, That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in that part of the decedent's gross estate which at the time of his death is situated in the United States and not deducted under paragraphs (1) or (3) of subdivision (b) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916;[51] and

(3) The amount of all bequests, legacies, devises, or transfers, except bona fide sales for a fair consideration, in money or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious, charitable, scientific, literary, or educational purposes within the United States. This de-

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[50] See page 1468.

[51] This subsection is identical with section 403 (a-2). For a full discussion, see page 1477.

duction shall be made in case of the estates of all decedents who have died since December 31, 1917.

No deduction shall be allowed in the case of a nonresident unless the executor includes in the return required to be filed under section 404 the value at the time of his death of that part of the gross estate of the nonresident not situated in the United States.

Except for the 10 per cent limitation included in paragraph (1) above, the section quoted provides the same general deductions for non-residents as in the case of resident estates. *The specific exemption of $50,000 does not, however, apply as far as non-resident estates are concerned.*

Regulation. The gross estate of a resident and of a nonresident are made up in the same way. In ascertaining the net estate, however, which is subject to tax, there is a radical difference between the two cases. Whereas the net estate in the case of a resident is determined by making the specified deductions from the entire gross estate, the net estate in the case of a nonresident is determined by making the deductions from the value of so much of the gross estate as is situated in the United States.[52] Thus, in substance, the statute attempts to tax only the transfer of so much of the estate of a nonresident as is situated in the United States. On the other hand, nonresident estates are not entitled to the specific exemption of $50,000. (Reg. 37, Art. 59.)

Deduction for claims and expenses of non-residents.—

Regulation. The character of the deduction is the same as in the case of resident estates (see Arts 37 to 49). It is immaterial whether the expenditures are incurred or paid in this country or elsewhere. The deduction, however, is subject to limitations which do not apply in the case of a resident estate. Only that proportion of the claims and expenses is deductible which the value of the property situated in the United States bears to the value of the entire gross estate, wherever situated; and in no event may a sum be deducted in excess of 10 per cent of the value of the property situated in the United States. This 10 per cent limitation does not apply to the deductions subsequently considered. (See Arts. 62, 63.) (Reg. 37, Art. 61.)

Deductions for public, charitable, or similar gifts by non-residents.—

Regulation. Where the bequest is to a corporation, it is limited to a domestic corporation; that is, one created or organized in the

[52] But not in excess of 10 per cent thereof. Act. section 403 (1).

United States. Where the bequest is to a trustee, it must be for use exclusively within the United States. The requirements are different and should not be confused. The first relates to the character of the donee; the second to the character of the use of the gift. With these exceptions the rules for deduction are the same as in the case of resident estates (see Arts. 53, 54).

This deduction applies to the estates of all decedents dying after December 31, 1917. In the case of any estate entitled to the deduction which paid the tax without receiving the benefit of the right, the excess tax will be refunded upon filing of claim for refund. (Reg. 37, Art. 63.)

Example of determination of net estate of non-residents.—

REGULATION. The following example will show the manner of determining the net estate, subject to tax, of a nonresident decedent. The gross estate of the decedent, wherever situated, amounts to $1,000,000, of which the property in the United States, Hawaii, and Alaska amounts to $200,000. The total legal deduction for claims and expenses (see Art. 61) amounts to $75,000; and there are charitable bequests, for use within the United States, amounting to $25,000. Inasmuch as the property in the United States, Hawaii, and Alaska constitutes 20 per cent of the entire gross estate, one-fifth of the total deductions for claims and expenses is the proportionate share corresponding to this property. This proportion amounts to $15,000; and as this amount does not exceed ten per cent of the property situated in the United States, Hawaii, and Alaska, the entire amount is deductible. The following result is accordingly obtained:

Gross estate within the United States		$200,000
Proportion of deductions for claims and expenses under subdivision 1	$15,000	
Charitable bequests in United States	25,000	
		40,000
Net estate subject to tax		160,000

The tax on this amount should be computed in the manner previously provided for estates of residents. (See Art. 8.)

In the example given, if the total legal deductions for claims and expenses had amounted to $150,000, the proportionate amount of deductions, $30,000, would not have been deductible, inasmuch as this would have exceeded ten per cent of the property in the United States, Hawaii and Alaska. In such case the total amount of the deductions allowable for claims and expenses would have been ten per cent of the gross estate within the United States, or $20,000, making, with the charitable bequests of $25,000, a total deduction of $45,000. The net estate subject to tax would accordingly have been $155,000, instead of the amount given in the example. (Reg. 37, Art. 64.)

It is presumed that insurance payable to individuals other than the executor in excess of $40,000 has been included in the gross estate in arriving at the $200,000.[53]

Payment of tax—non-residents.—

REGULATION. The regulations with reference to rates of tax and payment are the same in the case of estates of nonresidents as of residents. The statute provides that the executor shall pay the tax. If no executor or administrator has been appointed in the United States, every person in the United States in possession of any part of the decedent's gross estate is constituted an executor for the purpose of tax payment, and is liable for the tax upon the transfer of the portion of the gross estate in his possession. All checks, drafts, or money orders should be made payable to the order of Collector of Internal Revenue. Payment so made of an amount indicated to be due upon the return discharges the tax only in case subsequent investigation and audit disclose that the correct amount has been paid. (See Art. 90.) (Reg. 37, Art. 65.)

Sixty-Day Notice

Resident estates.[54]—In the case of a resident decedent, action is required on the part of the executor before the regular return is filed. It is necessary that he give written notice to the collector in the district wherein the decedent died of such death, of the approximate amount of the gross estate and of his appointment by the court or of his coming into possession of the property. This notice must be filed within two months (sixty days) after the executor has had his appointment confirmed by the courts.

LAW. Section 404. **That the executor, within two months[55] after the decedent's death, or within a like period after qualifying as such, shall give written notice thereof to the collector. . . .**

REGULATIONS. A preliminary notice, called the 60-day notice, is required to be filed in the case of every resident decedent who died on or after February 25, 1919, the gross amount of whose estate

[53] See Art. 60.
[54] For non-residents, see page 1493.
[55] The term "month" means calendar month (law, section 400).

exceeds $50,000. This notice must be filed in duplicate with the collector in whose district the decedent had his domicile at the time of death. Where there is doubt as to whether the gross estate exceeds $50,000, the notice should be filed, as matter of precaution, in order to avoid penalties.

Prior to February 25, 1919, the notice was required if the gross estate exceeded $60,000, or if there was any net estate after the deductions allowed by law, including the $50,000 exemption, had been taken. These provisions are not now in effect except to determine delinquency under previous acts.

In the case of the estates of nonresident decedents, notice is required if there is any property situated in the United States, without reference to its value. (Reg. 37, Art. 66.)

The executor or administrator of an estate is required to file notice on Form 704 within 60 days of his appointment by the court, or of coming into possession of any property of the estate, whichever event occurs first. The primary purpose of the notice is to advise the Government of the existence of taxable estates, and filing should not be delayed beyond the 60-day period because of uncertainty as to the exact value of the assets. Since the filing of the notice within the prescribed period is mandatory, the estimate of the gross estate called for by the notice is merely the best approximation of value which can be made within the time allowed. The instructions upon the back of the form should be read carefully before executing the notice. The signature of one executor or administrator upon Form 704 is sufficient. For penalties for delinquency in filing notice, or filing of false or fraudulent notice, see Articles 103 and 104. (Reg. 37, Art. 67.)

A detailed explanation under oath must accompany form 704 in the event of failure to file same within the time set by law.

Notice by others than the executor or administrator.—

Regulation. The notice upon Form 704 must be filed by others than the executor or administrator if either of the following situations exists:

(1) No executor or administrator has been appointed.

(2) There is property included in the gross estate, as defined by statute, which has not, and will not, come into the custody and control of the executor.

In these cases, the persons in possession of the property included in the gross estate are executors, within the meaning of the statute, for the purpose of filing the notice. (Reg. 37, Art. 68.)

Notice when no executor appointed.—

Regulation. Where no executor or administrator has been appointed, the person taking possession of property at the time of death is required to file notice within 60 days of the date of death. The notice must be filed whether possession of the property was held at the date of death, or was acquired thereafter. The notice on Form 704 must be filed by such persons in any case where an executor or administrator has not been appointed within 60 days of the decedent's death, although one is appointed subsequently. Where an executor or administrator is appointed within the 60-day period, the duty of filing the notice devolves upon him; and all other persons are relieved from liability to file with respect to property coming into the custody and control of the executor or administrator. (Reg. 37, Art. 69.)

Notice where property not within executor's control.—

Regulation. Where there is property that will not come into the custody and control of the executor, but which is included in the gross estate as defined by the statute, the notice on Form 704 must be filed within 60 days of the date of death by the person in possession or control of the property at the time of death.

The persons required to file Form 704, in compliance with this requirement, include the following:

(1) The surviving husband or wife in the case of property owned as tenants in the entirety.

(2) Donees who have received within two years prior to the decedent's death any gift of material value from the decedent, or who have received at any time whatever gifts made by the decedent in contemplation of death or intended to take effect at or after death.

(3) Trustees holding property conveyed during lifetime by decedent in contemplation of death, or with intent to provide for others at or after the decedent's death, regardless of the date of execution of the instrument making the conveyance.

(4) Fiduciaries holding property of any kind jointly for the decedent and another or others. Example: A savings bank holding a joint account in the name of the decedent and another, payable to either or to the survivor, must file Form 704 for the full amount of the account.

(5) Trustees having in charge property over which the decedent exercised a general power of appointment, and which will not come into the possession and control of the executor or administrator.

(6) Beneficiaries other than the executor who receive insurance upon the decedent's life, provided the total amount of the insurance receivable by all such beneficiaries exceeds $40,000.

The primary duty of filing notice with respect to property which

will not come into the executor's control rests upon the person actually in possession at the time of death. It is the duty of the succeeding owner, however, where property of this character is held at the time of death by an agent or fiduciary, to give notice within 60 days of the date of taking possession, unless he finds that notice has already been filed. For example, the appointee of property, under a general power of appointment exercised by the decedent, should file notice within 60 days of receiving possession, unless the notice has already been filed. (Reg. 37, Art. 70.)

INSURANCE COMPANIES' SIXTY-DAY NOTICE.—

REGULATION. Sixty-day notice upon Form 787 must be filed by every insurance company which pays insurance upon the life of a resident decedent to beneficiaries other than the executor or administrator in amounts aggregating more than $40,000, or which has knowledge of insurance payable to such beneficiaries by other insurance companies, aggregating, with amounts payable by the company itself, more than $40,000. If the proceeds of any policy are payable in the form of an annuity, the present worth of such annuity, for the purpose of deducting the $40,000 exemption, should be computed in accordance with the provision of Article 20. Notice should be filed with the collector of the district in which the decedent had his domicile within 60 days of receipt by the company of notification of death. If the insurance company is in doubt as to its liability to give notice, the notice should be filed.

Where insurance is taken out with a foreign branch of a domestic insurance company, the notice should be given by the home office of the company within 60 days of the receipt by the foreign branch of information of the decedent's death. (Reg. 37, Art. 71.)

WHERE MILITARY EXEMPTION CLAIMED SIXTY-DAY NOTICE REQUIRED.—

REGULATION. The executors of estates exempted from the tax (see Art. 9) are required to file the 60-day notice with the proper collector in the same manner as the executors of taxable estates. The executor should, in addition, write across the face of the form the words "Military exemption claimed." (Reg. 37, Art. 72.)

Under the provision covering military exemptions (section 401) the regulations demand that a formal claim for such exemption be submitted with the sixty-day notice, or as soon as possible thereafter, on form 793.[56]

[56] Reg. 37, Art. 10.

Non-resident estates.—

REGULATION. A 60-day notice on Form 705 should be filed with the Commissioner of Internal Revenue, Washington, D. C., by every executor or administrator appointed in the United States. The notice is necessary if any part of the decedent's gross estate was situated in the United States at the time of death, regardless of the value of that part or of the entire gross estate. If no executor or administrator has been appointed in this country, notice must be filed within 60 days of the date of death by every person in possession of any part of the gross estate in the United States. If such person has no knowledge of the decedent's death within 60 days of its occurrence, he should file this notice immediately upon obtaining such knowledge. The filing of notice by a foreign executor or administrator does not relieve persons in possession from the duty of filing notice. If there is a delay in the appointment of a local executor or administrator of more than 60 days after the death, persons in possession should file notice. The term "person in possession of property of the decedent" includes the decedent's agents or representatives. donees and transferees or trustees of property transferred in contemplation of death; the surviving owner of property held jointly; safe-deposit companies, warehouse companies, and similar custodians of property in this country of a nonresident decedent; brokers holding as collateral securities belonging to the decedent or investment funds owned by the decedent; banking institutions holding money on deposit or for any specific purpose, such as purchase of goods, if the title rests in the decedent; and debtors of the decedent in this country. (Reg. 37, Art. 73.)

TRANSFER AGENTS' SIXTY-DAY NOTICE.—

REGULATIONS. A 60-day notice upon Form 714 is required to be filed whenever a corporation, its transfer agent, register, or paying agent, is called upon to make a transfer of stocks or bonds, or to pay interest or dividends, to any successor in interest of any nonresident stockholder or bondholder who died after September 8, 1916, unless the transfer is made upon the order of an executor or administrator appointed in the United States. The notice is required for dividends declared prior to the day of death, and for interest which had accrued on bonds prior to the death of the decedent although payable thereafter. Notice should be filed with the Commissioner of Internal Revenue at Washington, D. C., within 60 days of the date of death, or immediately upon receipt of the order of transfer or payment. A transfer agent should be vigilant to report all cases in which the fact of the death of a nonresident appears. Where the securities are received without the personal assignment of the decedent, but with the transfer order of the foreign executor, it is clear that the case should

be reported. Where the securities bear the personal assignment of the decedent, the transfer should be reported if made upon the order of a foreign executor, or if information is received in any other manner that the record owner has died a nonresident of the United States. (Reg. 37, Art. 74.)

In order to prevent loss of the tax upon nonresident estates, it is essential that transfer agents should exercise great care in reporting all transfers of the kind described. Their records will be examined from time to time by internal-revenue officers to determine whether this regulation is being strictly complied with. Failure to file notice in the manner prescribed will render the transfer agent liable to a fine. (Reg. 37, Art. 75.)

Transfer of stock of non-resident decedent, how made.—

Regulation. Wherever a transfer agent is required to file 60-day notice as provided in Article 74, he shall not make transfer of the stock standing in the name of the decedent until there has been delivered to such collector of internal revenue as may be designated by the Commissioner the bond of the party to whom the stock is to be transferred with corporate surety in an amount to be fixed by the Commissioner, conditioned for the payment of the tax upon the transfer of the decedent's estate, not exceeding in amount the value of the stock to be transferred. Upon receipt of the 60-day notice the Commissioner will at once, upon request, fix the amount for which the bond is to be given. In lieu of the bond a deposit of the amount so fixed may be made with such collector of internal revenue as the Commissioner may designate. Where a sum of money is deposited in lieu of the bond, and it exceeds the amount of the tax as finally determined, the excess will be refunded to the person making deposit. In lieu of the provisions and restrictions hereinbefore set forth, transfer agents are authorized to make a transfer of stock standing in the name of a nonresident decedent to the duly qualified ancillary executor or administrator within the United States, who shall make a return on Form 706, as any other executor is required by law to do, provided that such transfer agent at the time of making such transfer gives notice thereof in writing to the Commissioner of Internal Revenue. (Reg. 37, Art. 75 A.)

Insurance companies' sixty-day notice.—

Regulation. The 60-day notice upon Form 788 must be filed by every domestic insurance company which pays insurance upon the life of the nonresident decedent in any amount either to a foreign executor or administrator, or to individual beneficiaries. The notice should be filed with the Commissioner of Internal Revenue, Wash-

ington, D. C., within 60 days of receipt of proof of claim. No notice is required to be filed, if the only insurance paid is receivable by an executor appointed in the United States. If, however, the company is liable to give notice, it is required to report insurance of all classes in order that its statement may be complete. (Reg. 37, Art. 76.)

PAYMENT OF LIFE INSURANCE POLICY.—

REGULATION. Wherever an insurance company is required to file a 60-day notice, as provided in Article 76, where the insured was a nonresident it shall not make payment of any policy or policies to a foreign executor or administrator, or to an individual beneficiary, until there has been delivered to such collector of internal revenue as may be designated by the Commissioner the bond of the party to whom the insurance is to be paid, with corporate surety in an amount to be fixed by the Commissioner, conditioned for the payment of the tax upon the transfer of the decedent's estate, not exceeding the amount of insurance payable under such policy to the executor, and the excess over $40,000 of the aggregate insurance payable to specific beneficiaries other than the executor or the estate of the decedent. Upon receipt of the 60-day notice the Commissioner will at once, upon request, fix the amount of the bond to be given. In lieu of such bond a deposit of the amount fixed may be made with such collector of internal revenue as the Commissioner may designate. If in lieu of the bond a sum of money is deposited, and such sum exceeds the amount of tax as finally determined, the excess will be refunded to the person making the deposit. In lieu of the bond or a deposit of money, where insurance is payable to a foreign executor or administrator, the insurance may be paid to ancillary executor or administrator appointed within the United States, provided that such ancillary executor or administrator shall have given bond with corporate surety in an amount sufficient, in the opinion of the Commissioner, to discharge the tax liability of the estate, not exceeding the amount of insurance subject to be included within the gross estate of the decedent.

Wherever insurance companies are required to file a 60-day notice, as provided in Article 71, where the decedent is a resident and there is subject to be included within the decedent's gross estate any excess over $40,000 in the aggregate of insurance payable to specific beneficiaries other than the executor or the estate of the decedent, the same provisions and restrictions in regard to payment of insurance shall apply and govern insurance companies as are set forth in this article in the case of nonresidents.

Where insurance companies are required to file a 60-day notice, as provided in Article 71 or in Article 76, if the decedent is a resident or nonresident, and there is an excess over $40,000 in the aggre-

gate of all insurance payable to specific beneficiaries other than the executor or the estate of the decedent, insurance companies are authorized, in lieu of the provisions and restrictions hereinbefore set forth, upon consent of the beneficiaries to make payment of such insurance to such beneficiaries through the duly qualified executor or administrator within the United States or through the duly qualified ancillary executor or administrator in the United States who shall make return on Form 706 of the excess over $40,000 of such insurance, if the estate be that of a nonresident, or that of a resident if there be a net estate subject to tax. (Reg. 37, Art. 76A.)

Returns

Returns for resident estates.—As with returns called for under the income tax laws, the returns under this title literally impose upon the executor the duty of assessing the amount of tax due. The correctness of this assessment is subject to final determination by the Commissioner.

The form of the return is practically a series of information schedules which may be summarized as follows:

1. General information sheet in regard to decedent, heirs, legatees, and beneficiaries.
2. Items under separate captions, going to make up the gross estate (schedules A to D).
3. Transfers, property passing under power of appointment, and property taxed within five years (schedules E to G).
4. Deductions classified (schedules H to K).
5. Recapitulation (schedule L).
6. Rates and tax due (schedule M).
7. Jurat for executors, etc.

Schedule M also calls for details to be supplied by nonresidents as to gross estate situated outside the United States.

Explicit and concise instructions are given regarding the information required, and these instructions should be followed in every particular.

LAW. Section 404. . . . . The executor shall also, at such times and in such manner as may be required by regulations made

pursuant to law, file with the collector a return under oath in duplicate, setting forth (a) the value of the gross estate of the decedent at the time of his death, or, in case of a nonresident, of that part of his gross estate situated in the United States; (b) the deductions allowed under section 403; (c) the value of the net estate of the decedent as defined in section 403; and (d) the tax paid or payable thereon; or such part of such information as may at the time be ascertainable and such supplemental data as may be necessary to establish the correct tax.

Return shall be made in all cases where the gross estate at the death of the decedent exceeds $50,000, and in the case of the estate of every nonresident any part of whose gross estate is situated in the United States. If the executor is unable to make a complete return as to any part of the gross estate of the decedent, he shall include in his return a description of such part and the name of every person holding a legal or beneficial interest therein, and upon notice from the collector such person shall in like manner make a return as to such part of the gross estate. The commissioner shall make all assessments of the tax under the authority of existing administrative special and general provisions of law relating to the assessment and collection of taxes.

Date of filing return.—

Regulation. A return on Form 706 is required in the case of every resident decedent who died on or after February 25, 1919, leaving a gross estate exceeding $50,000 in value. This return must be filed with the collector in whose district the decedent resided. It must be filed within one year after the date of death, unless an extension is granted, and must be in duplicate. In the case of decedents who died before February 25, 1919, the effective date of the Revenue Act of 1918, the return is required if the gross estate exceeds $60,000, or if there is any net estate after the legal deductions, including the $50,000 exemption, have been taken. In the case of estates of nonresidents return is required if the decedent owned any property in the United States regardless of value. (See Art 88.) (Reg. 37, Art. 77.)

Procedure where no return has been made.—

Regulation. The statute provides that if no return is filed for the estate of a decedent, or if a return contains a false or incorrect statement of a material fact, the collector or deputy collector shall make a return. The Commissioner may amend this return from such knowledge or information as he can obtain, through testimony or otherwise. A return so made by the Commissioner, or made by the collector and approved by the Commissioner, is a sufficient basis for assessing the tax. Where a tax is found to be due upon such

a return, the estate will be liable for penalties as well as for the tax. (Reg. 37, Art. 78.)

Investigation where return has been filed.—

Regulation. An investigation of every return for estate tax will be conducted to verify the accuracy of the return. The investigation will be made by special officers of the Bureau. The fact that an investigation is made does not reflect upon the competence or good faith of the executor, since investigations are required in all cases as a matter of administrative procedure. The executor should cooperate with the examining officer in order that the full tax liability may be definitely determined and the case closed. During the course of the investigation the examining officer will inspect the books and records of the estate, interview the executor and other persons having knowledge of the decedent's affairs, verify the value of the assets and the amounts of debts and administration expenses, and take such other steps as may be necessary to determine the correct tax.

It is the purpose of the Bureau to make these investigations as soon as practicable after the filing of the return. Whenever there are special and urgent reasons for an early investigation, the collector should be notified in order that the case may be given special attention. Upon completion of the investigation the executor will be apprised by the examining officer of his findings, and will be given an opportunity to discuss the case and present such data as he may desire, to be considered by the Bureau in connection with the examining officer's report. Upon the completion of the review and audit by the Bureau of the return and the examining officer's report, the executor will be informed by letter from the Commissioner of the result of the audit. If the letter contains notification of an unpaid balance of tax, the executor should make payment to the collector. After the expiration of 30 days from receipt of the notification interest will accrue upon the excess tax at the rate of ten per centum per annum. If the executor wishes to file claim for abatement of any part of the excess tax, such claim must be filed within 30 days of receipt of notification, or he may pay the tax in order to prevent the running of interest, and submit claim for refund. (Reg. 37, Art. 79.)

The foregoing regulation is in the nature of an outline of procedure which the Treasury follows after the executor has performed the requirements of the law in filing form 706. It is unfortunate that the Treasury is not subjected to a limitation of time as is the executor. In many cases there are "special and urgent reasons" why estates should be settled

with despatch. Particularly may this be said of an estate which must remain under the administration of an executor, with consequent cost and inconvenience to the legatees. While section 407 provides that the Commissioner, on written application of the executor, shall make a final settlement of the tax within one year from the receipt of such application, there seems to be no reason why the Treasury should not be compelled by law to do its business with ordinary despatch without a special application for settlement being necessary. A maximum time should be established, within which time the investigation must be completed and a final assessment agreed upon.

Promise of more speedy operation on the part of the sections responsible for audit and examination of estate tax returns is reflected in the statement that "changes in procedure and personnel have resulted in bringing work to a current basis and increased efficiency."[57] There were 11,833 estate tax returns filed during the year ended June 30, 1921, which produced just over $103,000,000. Examinations of these returns disclosed additional taxes due to the government amounting to over $13,000,000, or 12.9 per cent, an indication of the necessity for prompt audit so that executors may close estates within a reasonable time.

Who shall make the return.—

Regulation. The statute provides that the executor or administrator shall file the return. If there is more than one executor or administrator, the return must be made jointly by all. Where no executor or administrator has been appointed, every person in possession of any part of the gross estate is considered to be an executor for the purposes of the tax, and is liable for a return as to the property in his possession. The executor or administrator is required to make a return of the entire gross estate of the decedent, including property which will not come into his possession, such as property transferred by the decedent before death, and property owned by tenants in the entirety. If the executor is unable to make a complete return as to any part of the gross estate, he is required to give all the information he has as to such property, including a full description,

[57] *Report of Commissioner of Internal Revenue,* 1921.

and the name of every person holding a legal or beneficial interest in the property. Where the executor is unable to make a return as to any property, the statute requires every person holding a legal or beneficial interest therein, upon notice from the collector, to make return as to such part of the gross estate. For penalties for delinquency in filing return, or filing of false or fraudulent return, see Articles 103 and 104. (Reg. 37, Art. 80.)

Extension of time for filing return.—

Regulation. If it is impossible for the executor to file a complete return within a year from the date of death, he may make application to the collector for an extension of time for filing the return, stating in detail in his application the circumstances which prevent the filing of the return by the due date and setting forth briefly but fully a statement of what the gross estate consists, together with a statement of the amount of deductions claimed, provided that in the first instance the application be made at least 30 days prior to the due date of the return. If the collector is satisfied that a complete return can not be made he may grant extensions of time not to exceed 180 days from the due date, no single extension exceeding 60 days. At the expiration of the last extension period granted a return must be filed. If at that time it is still impossible to file a complete and accurate return, on account of the unsettled condition of the affairs of the estate, the return filed by the executor must be as complete as possible, and must set forth all the facts in his possession as to the gross and net estate. Such a return will be accepted by the collector; but the executor must file an amended return as soon as the condition of the estate permits. The granting of an extension of time for filing a return does not operate to extend the time for the payment of the tax, which is due one year after decedent's death unless the time for payment thereof be extended by the Commissioner, as provided in Article 93. Where application has been made for an extension of time to file a return, but no extension of time for the payment of the tax has been granted, the executor will be required to pay on the due date a sum of money sufficient, in the opinion of the collector, to discharge the tax, even though an extension of time to file the return has been or may be granted. The statements accompanying the application will be subject to investigation and verification in acting upon the application for extension and in fixing the amount which the executor will be required to pay on the due date of the tax as sufficient in the opinion of the collector to discharge the tax. (Reg. 37, Art. 81.)

Form of return.—

Regulations. The return must be made on Form 706, copies of which will be supplied by the collector. It must contain an itemized

inventory, by schedule, of the property constituting the gross estate, together with a full statement of deductions claimed, as therein provided. The instructions printed on the form should be carefully followed. All documents and vouchers used in preparing the return should be retained by the executor, so as to be available for inspection whenever required. Certified copies of the will, if any, must be submitted with the return, together with duplicate copies of the other documents required by the instructions printed on the form, or any documents which the executor may desire to submit with the return in explanation thereof. (Reg. 37, Art. 82.)

The statute provides that the executor, in addition to filing notice and return, shall furnish such supplemental data as may be necessary to establish the correct tax. It is therefore the duty of the executor to furnish upon request copies of any documents in his possession relating to the estate, or on file in any court having jurisdiction over the estate, appraisal lists of any items included in the gross estate, copies of balance sheets or other financial statements relating to the value of stock, and any other information obtainable by him that may be found necessary in the determination of the tax. Failure to comply with such a request will render the executor liable to a fine not to exceed $500, and proceedings may be instituted in the proper United States court to secure compliance with the requirement. (Reg. 37, Art. 83.)

Form of return—non-resident estates.—

Regulations. Pursuant to this provision the executor of a nonresident decedent is required to file with the return:

(1) Certified copy of will, or, if the decedent left several wills, to govern in different jurisdictions, certified copy of each will.

(2) Certified copy of inventory of foreign property filed under a foreign estate, succession or death-duty act; or, if no such inventory was filed, copy of inventory filed with the foreign court of probate jurisdiction.

(3) Certified copy of schedule of claims filed under a foreign taxing act in cases where such claims are presented for deduction. If any item of deduction is not included in the schedule, the affidavit of the foreign executor or administrator with reference thereto should be submitted.

The specified information is required, whether or not the executor wishes to claim deduction, and is subject to the provision of the statute (see Sec. 403) requiring him to include in his return the value of the gross estate situated in the United States. (Reg. 37, Art. 84.)

A return on Form 706 must be filed in duplicate with the Commissioner of Internal Revenue, Washington, D. C., or with such collector of internal revenue as the Commissioner may designate,

within a year from the date of death of every nonresident decedent, if any part of the gross estate of such decedent was situated in the United States at the time of his death. It is the duty of any executor or administrator appointed in the United States to file a return for the whole of that part of the gross estate situated in the United States, whatever its value. If there is no such executor or administrator, every person in possession of any part of the gross estate in the United States may be required to file a return for such part. Except as otherwise specifically provided by these Regulations, notice will be given to such persons, however, where a return is required; and they are relieved of the duty of filing returns by the appointment of an executor or administrator in the United States, but not, however, by the appointment of a foreign executor or administrator. If, however, a complete return is actually filed by the foreign executor of property in the United States, the person in possession need not file a return, except as otherwise specifically required by these Regulations. (Reg. 37, Art. 88.)

Returns are privileged communications.—

Regulations. All estate tax returns and notices are treated as privileged communications and may not be exhibited to any person other than the executor or his duly authorized attorney, except as stated in Article 86. This requirement of secrecy will be rigidly enforced, and extends to information of a private nature submitted or obtained in connection with a return or notice. The requirement does not operate to prevent internal revenue officers from disclosing the returned value of any item or the amount of any specific deduction where such disclosure is necessary in order to arrive at a correct determination of the tax. This right of disclosure, however, does not extend to such information as the amount of the estate, the amount of tax, or other general data. Nor are the records in possession of the Bureau, whether on file with the Commissioner or the collector, open to inspection, except as provided herein. (Reg. 37, Art. 85.)

Where any person other than the executor has a material interest in ascertaining any fact disclosed by the return, or in obtaining information as to the payment of the tax, he shall make a written application to the Commissioner of Internal Revenue for such information, setting forth the nature of his interest and the purpose of the application. The Commissioner will review the application, and, if it is approved, give written instruction to the collector to exhibit the return to the applicant, or give him such information as is specified. Under no circumstances shall the collector give information to persons other than the executor except upon the written order of

the Commissioner, and to the extent authorized by such order. (Reg. 37, Art. 86.)

In all cases where information is sought regarding an estate, or an interview asked, by an attorney whose name does not appear on form 706 as the attorney for the estate, the information or interview will be denied unless the attorney presents a signed statement from the executor, authorizing him to appear in his behalf. The limitation does not apply where an attorney asks a general ruling on a question relating to a specific estate, or where he asks information of the procedure to be followed in regard to filing notice or making payment. Where an attorney asks information, or an interview, and his name appears on the return as attorney for the estate, the information or interview will be granted if his identity is established. (Reg. 37, Art. 87.)

Return by collector.—

LAW. Section 405. **That if no administration is granted upon the estate of a decedent, or if no return is filed as provided in section 404, or if a return contains a false or incorrect statement of a material fact, the collector or deputy collector shall make a return and the Commissioner shall assess the tax thereon.**

LAW. Section 1311. [Rev. Stat., Section 3176.] **If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector, and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.**

REGULATION. Where the executor fails to file a return, or files an inaccurate one, the collector or deputy collector is required to make a return from such information as he possesses or is able to obtain. In such cases the Commissioner assesses the tax in the same manner as though the return had been filed by the estate. (Reg. 37, Art. 89.)

Payment of Tax

When tax due and payable.—In contradistinction to payments required in the case of income and excess profits taxes, the amount of an estate tax is not payable in instalments but in full one year after the date of the decedent's death. In view of the fact that the payment is made directly out of the corpus of the decedent's estate, there would be little reason for the spreading of such payment over any particular period. Should it happen that the selling of property or securities, in order to liquidate the liability at one certain time, would obviously be detrimental to the estate, but an extension of time might mean an alleviation of this hardship, the law empowers the Commissioner to grant such an extension up to a period of three years. Whether extension be granted or not, any tax due and not paid within one year and six months after date of decedent's death will be subject to interest at the rate of 6 per cent per annum from the date when the whole tax was originally due and payable.

Law. Section 406. That the tax shall be due and payable one year after the decedent's death; but in any case where the Commissioner finds that payment of the tax within such period would impose undue hardship upon the estate, he may grant an extension or extensions of time for payment not to exceed three years from the due date.

The executor shall pay the tax to the collector or deputy collector, and to such portion of the tax, not paid within one year and six months after the decedent's death, interest at the rate of 6 per centum per annum from the expiration of one year after such death shall be added as part of the tax irrespective of any extension or extensions of time that may have been granted for the payment of the tax, or any portion thereof.

Regulation. The tax is due and payable one year from the date of death. No discount will be allowed for payment in advance of the due date. The collector will grant to the person paying the tax duplicate receipts, either of which will be sufficient evidence of such payment, and entitle the executor to be credited with the amount by any court having jurisdiction to audit or settle his accounts.

Payment will not be accepted before a return in proper form has been filed, except in cases where an extension of time to file a return has been granted but no extension of time has been granted

within which to pay the tax, and the executor desires to make payment under section 407 of the act of an amount sufficient in the opinion of the collector to discharge the tax. Payment of the amount of tax shown to be due by a return accepted by the collector, executed in good faith and accurate so far as the executor could ascertain from his own knowledge and in the exercise of diligence, will be considered payment of the tax in full under section 407 of the act, subject to adjustment resulting from investigation, except as to any item which should have been but was not embodied in the return. If at the time payment is made the exact amount of the tax can not be determined, the payment of a sum of money sufficient, in the opinion of the collector, to discharge the tax will be considered payment in full, except as the tax is adjusted after investigation. (See Arts. 78, 95.) If the return filed contains a gross or fraudulent misstatement of fact, the payment of the amount of tax shown to be due thereby will not be deemed to be payment in full of the tax, since the collector's decision is based upon the assumption that the return is made in good faith. (Reg. 37, Art. 90.)

Payment of tax in Liberty bonds.—In accordance with section 14 of the Second Liberty Bond Act, as amended by the Third Liberty Bond Act, Liberty bonds bearing interest at a rate higher than 4 per cent may be used in payment of estate tax to the amount of par and interest accrued at the time of payment, provided such bonds have been owned continuously by the decedent for at least six months prior to his death.

REGULATION. Payment of the estate tax may be made by the delivery of Liberty Bonds or other bonds of the United States bearing interest at a higher rate than 4 per cent per annum, provided they were owned by the decedent for at least six months prior to the date of his death. Such bonds are received in payment to the amount of par and interest accrued at the time of the payment. . . . . (Reg. 37, Art. 91.)

The issues of Liberty bonds available for this purpose are:

First 4¼'s	issued	May 9, 1918
First Second 4¼'s	"	Oct. 24, 1918
Second 4¼'s	"	May 9, 1918
Third 4¼'s	"	May 9, 1918
Fourth 4¼'s	"	Oct. 24, 1918
Victory 4¾'s	"	May 20, 1919

[58] Victory 4¾ notes are acceptable under the Victory Liberty Loan Act of March 3, 1919.

The use of Liberty bonds for payments of the estate tax will prove advantageous where such bonds are selling below par. In any case in which it is proposed to pay the tax in Liberty bonds, reference should be made to Department Circular 225, dated January 31, 1921, containing detailed instructions which are too lengthy to reproduce here. The computation of accrued interest is to be made in accordance with the tables issued with the circular referred to.

Payment of tax by uncertified check.—Uncertified checks, if collectible at par, may be accepted in payment of the estate tax. The regulation is permissive, not mandatory.

REGULATION. . . . . Collectors may accept uncertified checks in payment of the estate tax provided such checks are collectible at par—that is, for their full amount, without any deduction for exchange or other charges. If the bank on which any such check is drawn should refuse to pay it at par, the check should be returned through the depositary bank, and be treated in the same manner as a bad check. All expenses incident to the attempt to collect such a check and the return of it through the depositary bank must be paid by the drawer of the check to the bank on which it is drawn, since no deduction can be made from amounts received in payment of taxes. (See Revised Statutes, Sec. 3210.) (Reg. 37, Art. 91.)

Right to reimbursement not enforcible by Treasury.—

REGULATION. Two rights are here given. Persons in possession of property, and paying the tax, are entitled to reimbursement, either out of the undistributed estate or by contribution from other beneficiaries, of any excess of the amount paid over the amount of the tax upon the particular property in their possession. The executor is also entitled to require beneficiaries under insurance policies to bear their proportion of the tax. These provisions, however, are not designed to curtail the right of the Bureau to collect the tax from any person, or out of any property, liable therefor. The Bureau may not be required to apportion the tax among the persons liable. For example, where a transfer has been made in contemplation of death, the Bureau may hold both the executor and the transferee liable with respect to the tax upon the property transferred. In such case, if the tax is paid by the executor, he may not look to the Bureau for relief by refund of part of the tax. (Reg. 37, Art. 98.)

Liability of transferee and insurance beneficiary.—Though property may have passed into the possession of a beneficiary through the medium of a trust made in contemplation of death or to take effect at or after death of decedent, and even in the case of insurance passing under contract to a specific beneficiary,[59] the property or proceeds are subject to a lien to secure payment of taxes due, to the extent of the decedent's interest therein at the time of transfer.

LAW. Section 409. . . . . **If (a) the decedent makes a transfer of, or creates a trust with respect to, any property in contemplation of or intended to take effect in possession or enjoyment at or after his death (except in the case of a bona fide sale for a fair consideration in money or money's worth) or (b) if insurance passes under a contract executed by the decedent in favor of a specific beneficiary, and if in either case the tax in respect thereto is not paid when due, then the transferee, trustee, or beneficiary shall be personally liable for such tax, and such property, to the extent of the decedent's interest therein at the time of such transfer, or to the extent of such beneficiary's interest under such contract of insurance, shall be subject to a like lien equal to the amount of such tax. Any part of such property sold by such transferee or trustee to a bona fide purchaser for a fair consideration in money or money's worth shall be divested of the lien and a like lien shall then attach to all the property of such transferee or trustee, except any part sold to a bona fide purchaser for a fair consideration in money or money's worth.**

REGULATION. The amounts of the lien and of the personal liability of the transferee, trustee, or insurance beneficiary are limited to the amount of the tax upon the transfer of the particular property in the possession of the person liable. Where the transferee or trustee sells the property to a *bona fide* purchaser for a fair consideration in money or money's worth, the lien upon such property is divested; but there is substituted a lien upon *all* of the property of the transferee or trustee, except such part as may be sold to a *bona fide* purchaser for a valuable consideration. (Reg. 37, Art. 101.)

The question of the taxability of insurance in favor of a third party has already been discussed in this chapter.[60] The right of recovery against the beneficiary, allowed the executor under section 408, in the case of the tax on such portion of the benefits received by him in excess of $40,000, inflicts a

[59] See page 1465.
[60] See page 1466.

direct tax on the beneficiary which is not in keeping with the general character of the tax imposed by the law. If an individual were bequeathed $50,000, he would receive the $50,000, provided there was sufficient residual property out of which the estate tax could be paid. In the case of an insurance policy in favor of a beneficiary for a like sum, the executor is given the power to collect the portion of tax applicable thereto from such beneficiary, irrespective of whether or not there is a sufficient residual estate to meet the demands of the tax. The rate at which a beneficiary, under these circumstances, would be taxed at the will of the executor, must necessarily be an arbitrary one dependent entirely upon the bracket which the final amount of the decedent's net estate reaches. An individual is interested to the extent of $3,000 insurance benefit in total benefits of this nature aggregating $100,000; the net estate amounts to $3,000,000. He is taxed 15.38 per cent on $2,000, i.e., 40/60 of his benefit. The amount of his legacy would be impaired to the extent of $307.60, or more than 10 per cent. Apart from any question of the legality of taxing proceeds from third party insurance, this provision not only works a hardship and imposes a direct tax on the beneficiary, but also has a further fault; the amount by which the beneficiary's legacy is reduced depends entirely on the total net estate of the decedent. This is an obviously unfair way of basing a tax on a beneficiary who has no other interest in the size of the estate.

Unpaid tax a lien on estate.—

LAW. Section 409. **That unless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent, except that such part of the gross estate as is used for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof, shall be divested of such lien. If the Commissioner is satisfied that the tax liability of an estate has been fully discharged or provided for, he may, under regulations prescribed by him with the approval of the Secretary, issue his certificate releasing any or all property of such estate from the lien herein imposed.**

Regulation. This lien attaches to every part of the gross estate, whether or not the property comes into the custody or control of the executor. The only property divested of the lien is such part as is used to pay charges against the estate and administration expenses allowed by the court which administers the estate. With this exception, the lien can only be divested by payment. It attaches to the extent both of the original tax shown to be due by the return and of any additional tax found to be due upon investigation. Payment of the entire tax is necessary in order to destroy the lien. (Reg. 37, Art. 99.)

Release of lien.—

Regulation. The statute provides that, if the Commissioner is satisfied that the tax liability of an estate has been fully discharged or provided for, he may issue his certificate releasing any or all property of the estate from the lien. The issuance of certificates is a matter resting within the discretion of the Commissioner, and certificates will be issued only in case there is actual need therefor. In most cases the receipts issued by the collector constitute sufficient acquittance.

The tax will be considered fully discharged for the purpose of the issuance of a certificate only when investigation has been completed, and payment of the excess tax determined to be due, if any, has been made. A certificate of release of lien may be issued by the Commissioner under these circumstances upon any or all property of the estate, upon the filing by the executor of an application in duplicate on Form 791. The form must contain all the information called for.

Where the tax liability has not been fully discharged, as provided above, no general certificate of release will be granted, but releases of lien upon particular items of property will be issued upon the filing with the Commissioner of such security, if any, as he may require. Where security is required, a corporate indemnity bond must be furnished, or Liberty Bonds, or other bonds of the United States, must be deposited with the collector. In lieu of such security, the Commissioner may in any case issue the release upon payment of the estimated tax upon the transfer of the property released, computed at the highest rate applicable to the estate. If, upon consideration of the application, the Commissioner finds the issuance of the certificate to be warranted, the collector will notify the executor of the amount of the bond, as fixed by the Commissioner. (Reg. 37, Art. 100.)

Penalties

There is only one penalty section under this title, making specific allusion to the sections dealing with the estate tax.

The general provision of the Revised Statutes regarding penalties, claims for abatement or refund, and other administrative questions are the same as apply to the other titles of the 1921 law. These are dealt with in detail in the respective chapters of this book.

LAW. Section 410. **That whoever knowingly makes any false statement in any notice or return required to be filed under this title shall be liable to a penalty of not exceeding $5,000, or imprisonment not exceeding one year, or both.**

Whoever fails to comply with any duty imposed upon him by section 404, or, having in his possession or control any record, file, or paper, containing or supposed to contain any information concerning the estate of the decedent, or, having in his possession or control any property comprised in the gross estate of the decedent, fails to exhibit the same upon request to the Commissioner or any collector or law officer of the United States, or his duly authorized deputy or agent, who desires to examine the same in the performance of his duties under this title, shall be liable to a penalty of not exceeding $500, to be recovered, with costs of suit, in a civil action in the name of the United States.

Classification of penalties.—

REGULATION. Two kinds of penalties are provided for delinquency with respect to the duties imposed by the estate tax law:

(1) A specific penalty, to be recovered by suit, unless adjusted by an offer in compromise; and

(2) A penalty of a certain percentage of the tax, to be added to the tax and collected in the same manner as the tax.

In any case of delinquency for which more than one penalty is provided the Government may impose either or both penalties. (Reg. 37, Art. 102.)

FALSE AND FRAUDULENT NOTICE OR RETURN.—

REGULATION. Where statements in the 60-day notice or in the return are knowingly and willfully false, the person making them is subject to a penalty of $5,000, or imprisonment for one year, or both; and, for the false return, 50 per cent may be added to the amount of the tax. (Reg. 37, Art. 103.)

FAILURE TO FILE NOTICE OR RETURN.—

REGULATION. For failure to file the 60-day notice or the return within the time prescribed, the person in default is subject to a penalty not to exceed $500; and, for the failure to file the return, 25 per cent may be added to the amount of the tax. Where it appears,

however, that the failure to file the return was due to a reasonable cause and not to willful neglect, no addition is made to the tax. (Reg. 37, Art. 104.)

Failure to exhibit records or property.—

Regulation. Where a person in possession or control of any record, file, or paper, supposed to contain information relating to the estate, fails to exhibit the same, upon the request of the Commissioner or any collector, he is liable to a penalty not to exceed $500, to be recovered by civil action. He must comply with such a request whether or not he believes that the documents contain information relating to the estate. A person in possession of property forming part of the gross estate, and refusing to exhibit the same upon the request of the Commissioner or a collector, is subject to a similar penalty. (Reg. 37, Art. 105.)

Claims for Abatement and Refund

Regulation. Under these provisions of law two forms of relief are afforded the executor in cases where he believes that an excessive amount of tax has been assessed against or paid by him, either upon the basis of the return or of the investigation conducted by the Bureau. The two forms of relief are:

(1) Claim for abatement on Form 47 where the tax has been assessed but not paid.

(2) Claim for refund on Form 46 where the tax has been paid. (Reg. 37, Art. 106.)

Form 843 will not be used instead of 46 or 47.

Claim for abatement.—

Regulation. Claims for the abatement of taxes or penalties illegally assessed must be made upon Form 47, and must be sustained by the affidavits of the parties against whom the taxes were assessed or of other parties cognizant of the facts. When a tax has been assessed, the presumption is that the assessment is correct; and the burden of showing that it was improperly or illegally assessed rests upon the applicant for abatement. The affidavit must therefore contain a full and explicit statement of all the material facts relating to the claim in support of which they are offered and which are essential to proper consideration. Nothing should be left to inference, but all the facts relied upon should appear upon the papers themselves. The filing of a claim for the abatement of a tax alleged to have been erroneously assessed does not necessarily operate as a suspension of the collection of the tax. The collector may collect the tax if he thinks it necessary, and leave the taxpayer to his remedy of a claim for refund. (Reg. 37, Art. 107.)

Accrual of interest as affected by abatement claim.—

Regulation. Where a claim for abatement is rejected, the making of the application does not affect the running of interest. The allowance of the claim, however, in whole or part, discharges all interest obligations upon the portion of the claim allowed. The same rules apply where, upon the request of the executor, a reinvestigation is made of the amount of an additional tax. (Reg. 37, Art. 108.)

Limitation of time to file claim for abatement of excess tax.—

Regulation. If it is desired to file claim for abatement of the excess amount of tax disclosed upon investigation, such claim should be filed with the collector within 30 days of receipt of the Commissioner's letter of notification. After that period the claim will not be considered, but the tax must be paid, and adjustment made by claim for refund. (Reg. 37, Art. 109.)

Power to compromise or remit penalties.—

Regulation. The Commissioner, with the advice and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal-revenue laws instead of commencing suit thereon, and with the advice and consent of the Secretary, and upon the recommendation of the Attorney General, may compromise any such case after suit thereon has been commenced by the United States. Accordingly, the power to compromise extends to (*a*) both civil and criminal cases; (*b*) cases whether before or after suit; and (*c*) both taxes and penalties. Refunds can not be made of accepted offers in compromise in cases where it is subsequently ascertained that no violation of law was involved. No power exists, however, to compromise a tax where its existence and amount are not disputed in good faith, and the taxpayer is solvent. Where a fine, penalty, or forfeiture, not exceeding $1,000 is incurred without willful negligence or fraud, it may be remitted by the Secretary of the Treasury; and he may remit other fines, penalties, forfeitures, and disabilities where the court has inquired into the matter and made findings. (Reg. 37, Art. 112.)

Claim for refund.—

Regulation. Claims for refund of assessed taxes and penalties must be made on Form 46. In this case, as in the case of claims for abatement, the burden of proof rests upon the claimant. All the facts

relied upon in support of the claim should be clearly set forth under oath. With the claim should be presented, in addition to the evidence:

(1) Collector's receipt evidencing payment of tax.

(2) Where the claim is made by the executor or administrator, a certified copy of the letters testamentary or of administration, and a certificate that the appointment remains in full force and effect.

(3) Where the executor or administrator has been discharged, a certified copy of the decree discharging him, and evidence as to the persons entitled to receive the refund, setting forth their names. Where the claim is made on behalf of a number of persons, there should be furnished a power of attorney duly executed by all the beneficiaries showing the claimant's authority to act in their behalf. (Reg. 37, Art. 110.)

Payment of claims.—

Regulation. Warrants in payment of claims allowed will be drawn in the names of the parties entitled to the money, and will, unless otherwise directed, be sent by the Treasurer of the United States directly to the proper parties, or their duly authorized attorneys or agents; but if the claimants are indebted to the United States for taxes such taxes must be paid before the warrants are delivered. (Reg. 37, Art. 111.)

Refund of tax arising from change in law.—Due to the changes in the deductibility of certain items made by section 403 (a-2-3) and (b-2-3), a refund of tax is possible in certain cases.

Law. Section 403. **(b) (3) . . . . In the case of any estate in respect to which the tax has been paid, if necessary to allow the benefit of the deduction under paragraphs (2) and (3) of subdivision (a) or (b) the tax shall be redetermined and any excess of tax paid shall be refunded to the executor.**

The paragraphs referred to in the foregoing have reference to the deductibility from the value of the gross estate in the case of (1) residents and non-residents, of (2) the value of property forming part of the gross estate of any person who died within five years of decedent, and (3) the amount of bequests, legacies, etc.

The deductions may be made in the case of the estate of any decedents who have died since December 31, 1917. Janu-

ary 1, 1918, is the effective date of the law of 1918, which first provides for the deduction of property coming under the specific headings enumerated in section 403 of the 1921 law.

Personal liability of executor.—

LAW. Revised Statutes, Sec. 3467 (Comp. Sts., 1916, Sec. 6373.) **Every executor, administrator, or assignee, or other person, who pays any debts due by the person or estate for whom or for which he acts, before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate for the debts so due to the United States, or for so much thereof as may remain due and unpaid.**

But see section 407 of the present law, discussed on page 1522.

Miscellaneous Provisions

Examination of records and taking of testimony.—

REGULATIONS. In order to ascertain the correctness of a return, or to make a return where none has been made, the Commissioner has power to require the attendance, and to take the testimony, of the person rendering the return, or any officer or employee of such person, or any other person having knowledge in the premises. Such person may be required to produce any relevant book, paper or other record. This power may be exercised by any revenue agent or inspector designated for the purpose. (Reg. 37, Art. 114.)

Where any person is summoned to appear and testify, or to produce books, papers, or other data, the District Court of the United States for the district in which such person resides has power to compel the giving of the testimony, or the production of the books, papers, or data, and to issue any appropriate process, writ, or order. (Reg. 37, Art. 115.)

Executor's duty to keep records.—

REGULATION. It is the duty of the executor to keep such records as the Commissioner may require. Executors are required to keep complete and detailed records of the affairs of the estate, sufficient to enable the Bureau to determine accurately the amount of the tax liability. (Reg. 37, Art. 117.)

Executor's duty to render statements.—

REGULATION. It is also the duty of the executor not only to make the formal return, but also to render any other sworn statement

which the Commissioner may require for the purpose of determining whether a tax liability exists. (Reg. 37, Art. 118.)

Scope of repeal.—

LAW. Section 1400. **(a) That the following parts of the Revenue Act of 1918 are repealed . . . . to take effect . . . .**

Title IV (called "Estate Tax"); on the passage of this act. . . . .

(b) The parts of the Revenue Act of 1918 which are repealed by this Act shall (unless otherwise specifically provided in this Act) remain in force for the assessment and collection of all taxes which have accrued under the Revenue Act of 1918 at the time such parts cease to be in effect, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any such taxes. In the case of any tax imposed by any part of the Revenue Act of 1918 repealed by this Act, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this Act takes effect under the provisions of this Act. The unexpended balance of any appropriation heretofore made and now available for the administration of any such part of the Revenue Act of 1918 shall be available for the administration of this Act or the corresponding provision thereof.

REGULATION. The Revenue Act of 1918 retains in force all taxes or penalties which had accrued prior to February 25, 1919. The *procedure*, however, with reference to the assessment and collection of all taxes, whenever they accrued, is governed by the statute from the time when it went into effect on February 25, 1919. (Reg. 37, Art. 119.)

Interest under Revenue Act of 1916.—

REGULATION. The Revenue Act of 1916 provides that, where the tax is not paid within one year and 90 days from the date of the decedent's death, interest shall be added at the rate of ten per centum per annum from the date of death. Where the specified period had elapsed prior to February 25, 1919, this penalty has been incurred, and is not affected by the passage of the Revenue Act of 1918. Where, however, the period of one year and 90 days had not elapsed prior to February 25, 1919, the Revenue Act of 1918 extends the time of payment to one year and 180 days from the date of death. These rules operate as follows:

Example: The year and 90 days, in a given case, expired on February 15, 1919, or ten days before the effective date of the Revenue Act of 1918. In this case interest at the rate of ten per centum per annum should be computed for the period of one year and 100 days from the date of death, or until the Revenue Act of 1918 took effect.

If the tax is thereafter paid within the time prescribed by the new act (which allows an additional 80 days), no further interest accrues. If it is not paid within that period, additional interest accrues at the rate of six per cent from February 25, 1919, when the Revenue Act of 1918 took effect.

Example: On February 25, 1919, in a given case, only one year and 80 days from the date of the decedent's death had elapsed. No penalty having been incurred, the estate has 100 additional days in which to make payment, viz., the year and 180 days prescribed by the Revenue Act of 1918. If, however, the tax is not paid within this period, interest accrues at the rate of six per cent from the expiration of one year from the decedent's death, as provided by the Revenue Act of 1918 (see Art. 94).

While no interest may be added to the tax unless payment thereof has not been made within one year and 180 days after decedent's death, the tax itself is due and must be paid within one year after the decedent's death unless an extension of time for the payment thereof has been granted by the Commissioner. (Reg. 37, Art. 120.)

Repeal of previous regulations.—

Regulation. The foregoing regulations are prescribed in pursuance of the authority conferred by the statute, and all rulings inconsistent with them are hereby revoked. (Reg. 37, Art. 121.)

Proceedings in United States Court for China.—

Law. Section 411. (a) That the term "resident" as used in this title includes a citizen of the United States with respect to whose property any probate or administration proceedings are had in the United States Court for China. Where no part of the gross estate of such decedent is situated in the United States at the time of his death, the total amount of tax due under this title shall be paid to or collected by the clerk of such court, but where any part of the gross estate of such decedent is situated in the United States at the time of his death, the tax due under this title shall be paid to or collected by the collector of the district in which is situated the part of the gross estate in the United States, or, if such part is situated in more than one district, then the collector of such district as may be designated by the Commissioner.

(b) For the purpose of this section the clerk of the United States Court for China shall be a collector for the territorial jurisdiction of such court, and taxes shall be collected by and paid to him in the same manner and subject to the same provisions of law, including penalties, as the taxes collected by and paid to a collector in the United States.

(c) The proviso in the Act entitled, "An Act making appropriation

for the Diplomatic and Consular Service for the fiscal year ending June 30, 1921," approved June 4, 1920, which reads as follows: *Provided*, That in probate and administration proceedings there shall be collected by said clerk, before entering the order of final distribution, to be paid into the Treasury of the United States, the same inheritance taxes from time to time collected under the laws enacted by the Congress of the United States from the estates of decedents residing within the territorial jurisdiction of the United States," is hereby repealed.

Apart from the particular application of the term "resident" indicated by the above section, there is the ordinary meaning of the term as generally used in the law. The question of citizenship does not enter into the matter at all; the two types of taxpayers involved being resident and non-resident. The interpretation of what constitutes a resident is given in the following:

Regulation. The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein within the meaning of the Revenue Act. An alien, by reason of his alienage, is presumed to be a nonresident alien.[61] Such presumption may be overthrown (1) in the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (a) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 or its equivalent, or (c) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States had been of such an extended nature as to constitute him a resident; (2) in other cases by (a) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien has filed Form 1078 or its equivalent, or (c) proof of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident.[62] . . . . (Art. 312.)

The definition contained in the regulations covering this title is not as fully explanatory as is that offered in the foregoing. The latter are not in conflict therewith, but form a

[61] This presumption reverses that of Reg. 45, Art. 312.
[62] These factors were previously to be found in Reg. 45, Art. 313.

detailed interpretation of what should actually constitute a resident under this title.

The particular definition included in section 411 having regard to *citizens* of the United States coming under the jurisdiction of the extra-territorial court in China, is necessitated in order to carry out the provision of the act alluded to in (c) of that section.

Who shall pay the tax.—The tax is paid by the executor. The mode of payment has already been fully discussed in this chapter, but a new provision in the 1921 law whereby the executor can be freed from his responsibility under certain circumstances[64] calls for further comment. This relief provision is more apparent than real. Under the rule laid down in the statute he cannot get the promised relief until the Commissioner has notified him of the amount of the tax, and such tax has been paid. Further, the Commissioner is permitted to take *one year* in which to furnish this information. In other words, the executor has to await the examination of his original return, the reassessment, if any, arising out of such examination, and the payment of the amount of any additional tax, before he can obtain his release, all of which proceedings may occupy a year to carry out. By the time he is relieved of his liability his executive duties, in the majority of instances, would have terminated and the liability for any further tax thereafter found to be due would be held against the beneficiaries, to the extent of their interests in the original estate.

REGULATION. The statute provides that the executor shall pay the tax.[65] This duty applies to the tax upon the transfer of the entire estate, including property which will not come into the possession of the executor or administrator. As to the personal liability of the executor, see Article 113. (Reg. 37, Art. 92.)

Extension of time for payment.—

REGULATION. In any case where the Commissioner finds that payment of the tax within one year after the decedent's death would

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[64] Law, section 407, see page 1521.

[65] Law, section 407.

impose undue hardship upon the estate, extensions of time will be granted for the payment of the tax for a period not to exceed in all three years from the due date. Extensions of time for tax payment will be granted only in exceptional cases, where it is evident that the payment of the tax within the statutory period would cause the estate serious financial loss. No extension shall be for more than one year, and a substantial payment shall be made before each extension. Application for extension of time for payment should be filed with the collector, and should contain a full statement of the facts upon which the application is based. The collector will refer the application to the Commissioner, with suitable recommendations.

The extension of time for the payment of the tax should not be confused with extension of time for filing the return. An extension of time to pay the tax does not relieve from the duty of filing the return within one year from the date of death. An extension of time for tax payment will not operate to prevent the accrual of interest upon the tax. (Reg. 37, Art. 93.)

The provision in article 93 regarding extension of time for payment has been uniformly interpreted to require the payment of at least 25 per cent of the tax on the due date.

The tax is due and payable one year after decedent's death (section 406). Under the foregoing section, proceedings for the collection of the amount due may be instituted directly thereafter. The same section in the 1918 law allowed a period of grace for payment to the extent of 180 days after the due date. In one case it was desired to take advantage of this section and the collector, ignoring section 408 of the 1918 law and justifying his action under Revised Statutes, section 3157, permitting distraint for recovery of taxes ten days after notice and demand, threatened immediately to distrain unless tax was paid in full. The 180-day period did not elapse for a further four months. The collector's right to collect under distraint was denied him.[66] Out of this case has probably arisen the change in the law omitting any reference to 180 days and making the tax due and payable date one year after decedent's death.

[66] *Polk et al. v. Page*, U. S. Dist. Court, Rhode Island, Advance Opinions, 270 Fed. 128, November 17, 1921.

Adjustment of tax after investigation.—

REGULATION. An investigation of every return for estate tax will be made by an internal-revenue officer, and the tax liability of the estate will be finally determined by the Commissioner upon the basis of such investigation. If at the time the Commissioner's determination is made the tax has been paid upon the basis of the return, an adjustment will be made of the amount of tax. If the amount of tax already paid exceeds the amount of tax as finally determined, the Commissioner will refund such excess payment to the executor. If the amount of tax as finally determined exceeds the amount of tax already paid, the collector will notify the executor of the amount of the unpaid balance of the tax and will demand payment thereof. Payment should be made by the executor immediately upon the receipt of such notification. Where the investigation of the return shows that no further tax is due, the executor will be notified to this effect. Until the receipt of such notification, he should reserve a sufficient portion of the estate to satisfy any excess tax. (Reg. 37, Art. 95.)

While the foregoing regulation demands immediate payment on notification of the unpaid balance, the law imposes interest on such balance only after a lapse of thirty days subsequent to notification. A month's credit is implied thereby.

INTEREST ON ADDITIONAL TAX.—

REGULATION. If an unpaid balance of tax is found to be due by the Commissioner after investigation, the statute provides that interest shall be added to the amount of such excess part of the tax at the rate of ten per centum from the expiration of 30 days after notification to the executor, provided the tax is not paid within such 30-day period. This interest will not begin to accrue, however, until the expiration of one year and 180 days after the decedent's death. (See Art. 94.)

If a return is filed containing a gross or fraudulent misstatement of fact, and payment made of the tax shown to be due thereby, such payment will not be considered payment in full within the meaning of the statute. (See Art. 90.) Consequently, in such a case, interest upon the unpaid balance of tax, determined after investigation, will be added at the rate of six per centum per annum from the expiration of one year after the decedent's death. (Reg. 37, Art. 96.)

Interest on unpaid tax.—

REGULATION. The statute provides that, if the tax is not paid within one year and 180 days after the decedent's death, interest at

six per centum per annum from the expiration of one year after the decedent's death shall be added as part of the tax. This provision applies to the original amount of tax shown to be due by the return accepted by the collector. It applies in all cases in which penalties have not accrued under the Revenue Act of 1916. (See Art. 120.) (Reg. 37, Art. 94.)

INTEREST ON ADDITIONAL ASSESSMENT.—

LAW. Section 407. That where the amount of tax shown upon a return made in good faith has been fully paid, or time for payment has been extended, as provided in section 406, beyond one year and six months after the decedent's death, and an additional amount of tax is, after the expiration of such period of one year and six months, found to be due, then such additional amount shall be paid upon notice and demand by the collector, and if it remains unpaid for one month after such notice and demand there shall be added as part of the tax interest on such additional amount at the rate of 10 per centum per annum from the expiration of such period until paid, and such additional tax and interest shall, until paid, be and remain a lien upon the entire gross estate. . . . .

Collector must issue duplicate receipts.—

LAW. Section 407. . . . . The collector shall grant to the person paying the tax duplicate receipts, either of which shall be sufficient evidence of such payment, and shall entitle the executor to be credited and allowed the amount thereof by any court having jurisdiction to audit or settle his accounts. . . . .

Commissioner to determine tax within one year.—

LAW. Section 407. . . . . If the executor files a complete return and makes written application to the Commissioner for determination of the amount of the tax and discharge from personal liability therefor, the Commissioner, as soon as possible and in any event within one year after receipt of such application, shall notify the executor of the amount of the tax, and upon payment thereof the executor shall be discharged from personal liability for any additional tax thereafter found to be due, and shall be entitled to receive a receipt or writing showing such discharge: *Provided, however,* That such discharge shall not operate to release the gross estate from the lien of any additional tax that may thereafter be found to be due while the title to such gross estate remains in the heirs, devisees, or distributees thereof; but no part of such gross estate shall be subject to such lien or to any claim or demand for any such tax if the title thereto has passed to a bona fide purchaser for value.

The paragraph in section 407 which permits an executor, by filing written application, to obtain his discharge from personal liability[67] for any subsequent assessment is a new provision. Under the 1918 law, executors have been held responsible for estate taxes imposed long after the estates themselves have been closed.

Collection of tax.—

LAW. Section 408. **That if the tax herein imposed is not paid on or before the due date thereof the collector shall, upon instruction from the Commissioner proceed to collect the tax under the provisions of general law, or commence appropriate proceedings in any court of the United States, in the name of the United States, to subject the property of the decedent to be sold under the judgment or decree of the court. From the proceeds of such sale the amount of the tax, together with the costs and expenses of every description to be allowed by the court, shall be first paid, and the balance shall be deposited according to the order of the court, to be paid under its direction to the person entitled thereto. . . . .**

The foregoing section omits a provision which appeared in the 1918 Act restraining the collector from enforcing payment should there be reasonable cause for further delay. Since the procedure is now dictated by instructions from the Commissioner, appeal to him is required if delay is necessary (section 406).

REGULATIONS. The remedy by action, here provided for, is not exclusive. For other available remedies for the collection of the tax, see Article 116. (Reg. 37, Art. 97.)

The provision of the statute quoted above applies to the estate tax law; and three remedies are thus provided for the collection of the tax:

(1) The collector may issue warrant of distraint authorizing the seizure and sale of any or all of the assets of the estate. (See R. S. Secs. 3187 et seq.; Comp. Sts., 1916, Sec. 5909 et seq.)

(2) The collector may commence in any court of the United States appropriate proceedings, in the name of the United States to subject the property of the decedent to sale under the judgment or decree of the court. (See Sec. 408; Art. 97.)

(3) The personal liability of the executor, of the transferee or

[67] Rev. Stat., section 3467.

trustee of property transferred in contemplation of death, and of the beneficiary of taxable life insurance (See Art. 101) may be enforced by any appropriate action. (Reg. 37, Art. 116.)

Reimbursement.—

LAW. Section 408. . . . . **If the tax or any part thereof is paid by, or collected out of that part of the estate passing to or in the possession of, any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts, or other charges against the estate, it being the purpose and intent of this title that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution. If any part of the gross estate consists of proceeds of policies of insurance upon the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds, in excess of $40,000, of such policies bear to the net estate. If there is more than one such beneficiary the executor shall be entitled to recover from such beneficiaries in the same ratio.**

CHAPTER XLI

FEDERAL CAPITAL STOCK (EXCISE) TAX

As a means of raising additional revenue, Congress in 1916 imposed an excise tax, effective January 1, 1917,[1] on corporations for the privilege of doing business. Since that date many unsuccessful attempts have been made to repeal or change the law.[2] The net result of the changes from 1916 to January 1, 1922, is an increase in the rate and a reduction in the exemption. The 1921 law (which, as to the capital stock section[3] does not become effective until July 1, 1922) re-enacted the tax in substantially the same form as it appeared in the 1918 law, the principal change being that insurance companies subject to tax imposed by section 243 or section 246 of the 1921 law are exempt from the capital stock tax.[4]

The rate now in force for domestic corporations is $1[5] for each full $1,000 of the average fair value of the capital stock for the year preceding the taxable year in excess of the exemption of $5,000.[6] The rate is comparatively low and the exemption such that the total tax is not excessive.

In his report for 1919 the Commissioner states: "The early regulations touching valuations have been radically elaborated and modified until under present approved methods it

[1] Title IV of the Revenue Act of September 8, 1916 (Public No. 271, 64th Congress).

[2] In considering the Revenue Act of 1921 the Senate Finance Committee omitted the tax.

[3] Section 1000.

[4] **[Former Procedure]** Section 1000 (c) of 1918 law read "The taxes imposed by this section shall apply to mutual insurance companies." Stock companies were taxable as ordinary corporations (Reg. 50, Art. 22). Organizations doing business on reciprocal or inter-indemnity plan were subject to tax. (C. B. 4, page 272; L. O. 1003.)

[5] The rate under the 1916 law was 50 cents for each $1,000, and the exemption was $99,000. The rate was increased to $1 and the exemption reduced to $5,000 by the 1918 law. The provisions of the 1918 law (passed February 24, 1919) were made retroactive to July 1, 1918.

[6] Foreign corporations, however, are not permitted any deduction.

has become necessary to individualize each case, considering all elements and factors which throw light on values and harmonizing them so far as possible in the ultimate values found."

This is an admission that the earlier regulations were wrong. The early administration of the law did not reflect credit on the Treasury. Originally an attempt was made to divide corporations into a few classes and value the capital stock of all companies in each on practically the same basis. During recent years, however, there has been a continuous improvement in administration.

Theoretically, the tax is on the privilege of doing business in a corporate capacity, but it is difficult to assess a tax on the "fair" value of capital stock without considering past earnings, so that in this respect the tax amounts to a duplication of the income tax.[7]

When the law was enacted all the arguments as to the difficulty of administering a property tax were ignored. The injustice of placing a burden upon an unprofitable business was brushed aside. The tax does not apply to individuals and partnerships. It is somewhat similar to various state laws imposing what are known as taxes on "corporate excess." Tax commissions have frequently commented on this system of taxation as having caused much difficulty, and litigation has been frequent. Apparent market value is never to be taken as conclusive, because the courts will permit a taxpayer to point out any unfairness in an assessment based thereon. Earning power is never to be taken as the sole factor of valuation because earnings fluctuate too greatly.

All the corporations (educational, fraternal, etc.) exempt under the income tax law are also exempt from this tax. In addition, many corporations organized for profit but not

[7] This condition is to some extent overcome by reason of the fact that the capital stock tax is an allowable deduction from gross income in determining the net income subject to the income and excess profits taxes. With the repeal of the high excess profits tax rates the relative burden of the capital stock tax increases.

"doing business," as interpreted by the Supreme Court of the United States, are also exempt. This applies to lessor, inactive and similar corporations.

The tax is due in advance and the next return will be due in July, 1922. The law [section 1000 (a-1)] provides that the computation of the tax of a domestic corporation shall be based on "the fair average value of its capital stock for the preceding year." Therefore, the return due in July, 1922, will be based on the average value, etc., during the year July 1, 1921, to June 30, 1922—the government's fiscal year.[8]

The Treasury has issued regulations[9] which are reproduced in the following pages, governing the preparation of returns, etc. The law is wisely silent as to many details which usually encumber tax bills.

In his report for 1920 the Commissioner states that—

Owing to the retroactive feature of the Revenue Act of 1918, which was passed February 24, 1919, changing the rate and lowering the exemption, the work of the division was greatly increased; but

[8] The following provision is made on form 707 for a corporation's fiscal year which ends at some date other than June 30: "In item 7 on page 1 hereof the taxpayer will show the closing date of its fiscal year ended between July 1, 1921, and June 30, 1922, if other than June 30, and the information furnished under exhibits A, B and C will be as of the year or years ended on such date, which should be used annually."

[9] [Former Procedure] Regulations 38 were issued October 19, 1916. Regulations 38 (revised) were issued August 9, 1918. Regulations 50 were issued April 29, 1919. Regulations 50 (revised) were issued June 21, 1920, and are still in effect. In the opinion of the author the requirements of the 1916 regulations were reasonable but T. D. 2503 (June 25, 1917) imposed new methods of ascertaining the "fair value" of the corporate stock which were fallacious, not in accord with the law and unenforceable.

As the valuation of capital stock is the basis for the assessment of the tax, the importance of a correct formula for calculating "fair value" should not be underestimated. Detailed criticism of the regulations will be found in *Income Tax Procedure*, 1918, pages 628 to 677.

Regulations 38 (revised, 1918) and Regulations 50 (April, 1919) did not continue the former objectionable instructions. Therefore, it is considered unnecessary to repeat in this book most of the comments on the original regulations. But taxpayers whose returns for the fiscal year ended June 30, 1918, and earlier periods have not been examined or finally settled should refer to the 1918 edition of this manual.

From information which has come to the author it seems that very many close corporations were over-assessed, but that practically no corporation whose stock was listed on an exchange was so treated. The corporations which were over-assessed should apply for a refund.

the audit of returns for the taxable period ended June 30, 1919, was practically completed by January 1, 1920, except in the case of corporations delinquent in filing returns, or cases reopened by reason of additional information contained in subsequent returns or obtained by field investigation. The audit of the returns for the taxable period ended June 30, 1920, was begun immediately, and it will be completed by the time the returns filed for the coming year are arranged for audit.

Difficulty has been encountered in procuring and retaining capable examiners, owing to the qualifications required. This division has evolved into a staff of valuation experts on questions of estimating the worth of collateral securities and all forms of property. It requires men of sound judgment, a general knowledge of business conditions, and some knowledge of law, accounting practice, and financing procedure. During the year the number of employees was reduced from 148 to an average working force of 115, and at the same time the work has been kept on a current basis.

A revision of capital stock tax regulations has been accomplished with a view to putting into taxpayers' hands complete information for the preparation of returns. The modifications in the regulations are not extensive, but changes of importance have been made in the provisions relative to tentative returns; to cases where a change in number of shares has occurred in the outstanding stock of a corporation during the year immediately preceding the taxable period; to questions of parent and subsidiary corporations or affiliated corporations; and to questions of classifying corporations exempt on account of personal service.

Returns are checked with those of previous years to detect inconsistencies. Periodical conferences are held between group heads and administrative officers of the division, in order that the examining force may receive the benefit of conclusions reached and the interpretations placed upon the law and regulations, from the consideration of intricate cases actually before the division for determination.

And in his report for 1921 the Commissioner states: "During the year this division has evolved a staff of valuation experts on questions pertinent to an equitable administration of the capital-stock tax."

For convenience the text of the 1921 law and such part of Regulations 50 (revised June, 1920) applicable thereto will be reproduced herein.

Regulations 50 (revised June, 1920) interpret the 1918 law. Regulations under the 1921 law have not yet been issued. The capital stock tax section of the 1921 law becomes effec-

tive July 1, 1922. The 1918 law continues in effect until the 1921 law becomes effective."

Domestic Corporations

Effective date.—

REGULATION. . . . . Special taxes of which this is one, become due on the first day of July[11] in each year, or on commencing any trade or business on which such tax is imposed. In the former case the tax is for one year, and in the latter case it is for the period from the first day of the month in which the liability to the special tax is incurred to the first day of July following. . . . . No portion of the tax is refundable where a corporation ceases to do business during the year. (Reg. 50, revised, Art. 1.)

The foregoing regulation is based on section 3237, Revised Statutes,[12] which applies to the assessment of special taxes. As to corporations organized and beginning corporate activities after July 1 in any year, however, section 3237 is superseded by the act imposing the federal capital stock tax. Section 1000 (b) of the law, quoted on page 1535, specifically provides that the tax "shall not apply in any year to any corporation which was not engaged in business . . . . during the preceding year ending June 30." This limitation is recognized in article 26 of Regulations 50, which will be found on page 1536.

Scope of tax.—

LAW. Section 1000. **(a) . . . . (1) Every domestic corporation . . . .**

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[10] Section 1400 of 1921 law.

[11] Corporations whose fiscal years end at dates other than June 30 may submit figures based on their own fiscal years. (Instructions 2, form 707).

[12] LAW. "All special taxes shall become due on the 1st day of July, 1891, and on the 1st day of July in each year thereafter, or on commencing any trade or business on which such tax is imposed. In the former case the tax shall be reckoned for one year, and in the latter case it shall be reckoned proportionately from the 1st day of the month in which the liability to a special tax commenced to the 1st day of July following." [Section 3237, Revised Statutes, as amended by Section 53 of the act of October 1, 1890 (26 Stats., 567).]

Definition of domestic corporations.—

REGULATIONS. A domestic corporation is a corporation created or organized in the United States, which includes the States, Territories of Alaska and Hawaii, and the District of Columbia. (Reg. 50, revised, Art. 8.)

The term "corporation" includes associations, joint-stock companies, whether created by statute or by contract, and insurance companies, but not partnerships, properly so called, and whether or not organized for profit or having a capital stock represented by shares. (Reg. 50, revised, Art. 2.)

Personal service corporations.[13]—Section 1000 of the 1918 law imposes a capital stock tax upon all domestic corporations except those enumerated in section 231 of that act. Among the corporations thus exempted [subdivision (14)] are personal service corporations. Section 1000 of the 1921 law provides that on and after July 1, 1922, "in lieu of the tax imposed by Section 1000 of the Revenue Act of 1918," every domestic corporation, except those enumerated in section 231 of that law, shall pay a capital stock tax. Section 231, subdivision (14), exempts personal service corporations with this limitation: "This subdivision shall not be in effect after December 31, 1921." Both laws specifically provide that the taxes imposed shall not apply to any corporation which was

[13] **[Former Procedure]** Under the 1918 law [section 231 (14)] personal service corporations were exempt because they were taxed as partnerships. Insurance companies were subject to tax under the 1918 law (including tax for the year beginning July 1, 1921) but not under the 1921 law. The capital stock tax section of the 1921 law is not effective, however, until July 1, 1922.

To be exempt from the capital stock tax under the 1918 law, personal service corporations were required to be granted full classification as such by the Income Tax Unit for the purpose of the income and profits taxes.

Art. 28, Reg. 50 (revised), required that returns be filed and fair value of capital stock shown. Tax was not to be computed, however, and in lieu thereof the words "exemption claimed" inserted. A full statement of the reasons for claiming exemption was required to be attached to the return.

REGULATION. " . . . . To be exempt from capital stock tax, corporations must have previously been granted full classification as personal service corporations for the purpose of Federal income and profits taxes under Regulations 45, revised." (Reg. 50, revised, Art. 27.)

not engaged in business during the preceding year ending June 30. It will be noted that the capital stock tax imposed by the Act of 1921 takes effect "on and after July 1, 1922," and is "in lieu of the tax imposed by Section 1000 of the Revenue Act of 1918." It would seem that by virtue of section 1400 (b) of the 1921 law the capital stock provisions of the 1918 law remain in effect until July 1, 1922, except that after December 31, 1921, personal service corporations are no longer exempt from the tax imposed thereby. It may readily be, therefore, that Congress intended that a tax should be imposed, under the 1918 law, upon personal service corporations from and after December 31, 1921.

The statute, however, affords no justification for the imposition thereof. Presumably, as the tax imposed by both the 1918 and 1921 laws is an excise tax, it was for the privilege of doing business for the *whole* year or such part thereof as any corporation might see fit to remain in business. The 1921 law sets up no standard by which it is possible to determine what proportion of the tax shall be imposed for the privilege of doing business from December 31, 1921, until July 1, 1922. There is nothing in the law to show that Congress intended to make the tax retroactive so as to cover the period from July 1, 1921, to December 31, 1921. Indeed, by failing to subject personal service corporations to the tax in question as soon as the law should take effect, demonstrates a contrary intent. Without express authority from Congress, it would certainly be improper to impose a tax equal to that which is exacted from corporations for the privilege of doing business for a *whole* year. On the other hand, to attempt to apportion the tax would be illegal because there is no statutory authority for doing so. Taxes cannot be imposed or exacted except by express legislative authority. There thus appears to be a lapse in the law (a situation of frequent occurrence), and by reason thereof no tax can be imposed under the 1918 law on personal service corporations, nor under the 1921 law until July 1, 1922. Section 3237 of the Revised Statutes is not applicable because

the provisions thereof which provide for the reckoning of taxes proportionately apply only to a trade or business which was *commenced* after the first of July in any given year.

ASSOCIATIONS AND LIMITED PARTNERSHIPS WHICH ARE INCLUDED.—

REGULATIONS. Associations and joint-stock companies include organizations, by whatever name known,[14] which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributable among the members or shareholders on the basis of the capital stock held by each, or, where there is no capital stock, on the basis of the proportionate share of capital which each has or has invested in the business or property of the organization. . . . . An organization, the membership interests in which are transferable without the consent of all of the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association. (Reg. 50, revised, Art. 3.)

The test of liability in all cases involving trusts of the Massachusetts type is whether the cestuis que trustent have by the terms of the trust agreement a voice in the management or control of the trust. Where the trustees are in complete control of the business, the beneficiaries having no control except the right of filling vacancies among the trustees or of consenting to a modification of the terms of the trust or of dissolving the trust, no association exists. If, however, the cestuis que trustent have a voice in the control or management of the business of the trust, whether through the right to elect trustees periodically or to remove the trustees or to restrict the trustees as to the management of the trust or otherwise, the trust is an association within the meaning of the statute. Where the trustees hold in their own right a sufficient number of the certificates of beneficial interest to constitute control as between the beneficiaries, the trust will be held to be an association regardless of the powers conferred upon the trustee by the instrument creating the trust. (Reg. 50, revised, Art. 7.)

A partnership bank, conducted like a corporation and so organ-

[14] "Massachusetts trusts" were held to be exempt from the excise tax in *Eliot v. Freeman, et al.* [220 U. S. 178, 55 L. Ed. 424, 31 Sup. Ct. 360, (T. D. 1686)], and corporations in hands of a receiver are exempt. (T. D. 2424.) In *Crocker v. Malley* (249 U. S. 223, 63 L. Ed. 573, 39 Sup. Ct. 270, 2 A. L. R. 1001) certain types of Massachusetts trusts were held not to be "associations" of the corporate type.

ized that the interests of its members may be transferred without the consent of the other members, is a joint-stock company or association within the meaning of the statute. A partnership bank, the interests of whose members can not be so transferred, is a partnership. (Reg. 50, revised, Art. 6.)

Partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships, and are taxable as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. Michigan partnership associations are corporations. The liability of Virginia limited partnerships is determined in each case from a consideration of the certificate of partnership and all pertinent facts relative thereto. (Reg. 50, revised, Art. 4.)

Since the tax is imposed upon the privilege of doing business as a corporation, the foregoing article appears to be too sweeping in its terms. The courts may be expected to interpret the law so as to exclude rather than include doubtful cases.[15]

Article 1506 of Regulations 45, issued in regard to income and profits taxes, originally provided that "Michigan and Virginia partnership associations are corporations"; but this article was amended by T. D. 2943 (November 6, 1919) to exclude Virginia partnership associations. See further articles 1505 and 1506 of Regulations 62.

Limited partnerships which are not included.—

Regulation. So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or transfer of the interest of a general partner, and which can not hold real estate or sue in the partnership name, are so

[15] *Crocker v. Malley*, 249 U. S. 223, 63 L. Ed. 573, 39 Sup. Ct. 270, 2 A. L. R. 1001.

like common law partnerships that they can not be differentiated therefrom for tax purposes. Michigan and Illinois limited partnerships are partnerships. California special partnerships are partnerships. (Reg. 50, revised, Art. 5.)

Corporation Must be "Doing Business" to be Taxed

LAW. Section 1000. **(a) . . . . (1) . . . . shall pay annually a special excise tax with respect to carrying on or doing business, ...**

REGULATION. The basis of the tax in the case of a domestic corporation is "carrying on or doing business" in the capacity of a corporation, association, or insurance[16] company. The words "carrying on or doing business" must be given their ordinary and natural signification. "Business" is a very comprehensive term and embraces whatever occupies the time, attention or labor of men for the purpose of livelihood or profit. In other words, business necessarily involves the idea of gain.

The true basis of distinction is, in the first instance, between—

(*a*) A corporation organized for the purpose of doing business as above defined, and

(*b*) A corporation organized for the sole purpose of owning and holding property and distributing its avails;

and, in the second instance, between—

(*c*) A corporation of class (*a*) which is continuing the body and substance of the business for which it was organized or is still active and maintaining its organization for the purpose of continued efforts in the pursuit of profit or gain, and

(*d*) A corporation which, although included in class (*a*), has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only the acts necessary to the maintenance of its corporate existence and the private management of its purely internal affairs.

The distinction in each case must depend upon the peculiar facts in the case. Corporations of class (*a*) will be presumed to be subject to the tax unless they submit proof, satisfactory to the Commissioner, that they are not actually carrying on or doing business. If a corporation claim exemption on the ground that it belongs to

[16] Insurance companies subject to the income tax imposed by section 243 or 246 of the 1921 law are now exempt from capital stock tax. They were taxable under the 1918 law. Certain other insurance companies, described in section 231 (10), are also exempt.

class (*b*), it will be required to file an excerpt from its charter setting forth its corporate powers together with a full and comprehensive statement showing the nature of the activities in which it is and has been actually engaged. If it claim exemption on the ground that it belongs to class (*d*), it will be required to furnish a copy of any amendment of its charter, resolution of its board of directors, or other evidence, satisfactory to the Commissioner, showing that it has reduced its activities to the mere ownership of property, receipt of its avails, and the doing of only what is necessary to the maintenance of its corporate existence.[17] (Reg. 50, revised, Art. 10.)

"Doing business" illustrated.[18]—

Regulation. Corporations organized for the purpose of and actually engaged in such activities as buying, selling, or dealing in mineral or timber land, or other real estate; leasing property, collecting rents, managing office buildings, making investments of profits; leasing lands and collecting royalties, managing wharves, dividing profits; and in some cases investing the surplus, are engaged in "carrying on or doing business" within the meaning of the statute.

A corporation organized for the purpose of, and actually engaged in, buying mineral or timber land or other real estate and holding it with a view to future sale at an advance is carrying on or doing business.

A corporation organized for the purpose of owning and leasing real estate which has leased all of the property under its control is still engaged in doing business unless, under the terms of its lease, its activities have been reduced to the mere receipt and distribution of the avails of the leases at the actual cost of so doing. If it is still maintaining its organization for the purpose of continued effort in the pursuit of profit and gain it is doing business.

A corporation owning or managing real estate which leases all of its property but under the terms of the lease is required to maintain or keep the property in repair is doing business.

A corporation engaged in mining or in developing and speculating in mineral lands is doing business.

A corporation engaged in buying and selling securities or other property is doing business even though for a period it makes no purchases or sales because of unfavorable market conditions.

A corporation formed to take over miscellaneous stocks, bonds or other property (as of an estate), to negotiate sales of various items from time to time as opportunity and judgment dictate, and to dis-

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[17] This regulation elaborates the former regulation but makes no important change in substance.

[18] For court decisions bearing on liability and non-liability to tax, see *Income Tax Procedure*, 1918, pages 654-659.

tribute the profits from time to time as liquidation is effected, is, while so engaged, carrying on or doing business.

A parent corporation which finances or manages the operations of its subsidiaries is doing business.

A so-called holding company which, under its charter, is authorized to and does, in addition to receiving and distributing the avails of the property or securities, held by it, finance the operations of its subsidiaries, is engaged in doing business.

A corporation organized for the purpose of taking over and holding securities, timber lands, coal lands, or other real estate, is held to be doing business, if it makes investments or reinvestments of its surplus income or funds in excess of an amount necessary to maintain its original investments.[19] (Reg. 50, revised, Art. 11.)

Not "doing business" illustrated.—

REGULATION. Holding companies as distinguished from parent corporations, and corporations all of whose property and business is operated by, or is in the hands of, a receiver or the Alien Property Custodian, are not doing business.

A holding company is defined as one whose corporate powers are limited to the mere owning and holding of property and distribution of its avails, or one which, although incorporated for the purpose of doing business as defined in article 10, has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its purely internal affairs.

A holding company, as above defined, will not be considered to be doing business by reason of the reinvestment of its surplus income or funds to the extent only of maintaining its original investments.[20] (Reg. 50, revised, Art. 12.)

Corporations Which Are Not Subject to the Tax

LAW. Section 1000. . . . . **(b) The taxes imposed by this section shall not apply in any year to any corporation which was not**

[19] This is only elaboration of a former regulation.

[20] [Former Procedure] T. D. 2429, dated January 4, 1917, held that a holding company (having several subsidiaries), the only business of which was "to receive dividends and interest from the operating companies, pay interest on its own indebtedness and distribute its surplus income as dividends among its own stockholders," is engaged in business within the meaning of the act of September 8, 1916, and is subject to the capital stock tax. It will be noted that this decision has been reversed and corporations with activities limited to those described are not liable to the tax.

engaged in business (or, in the case of a foreign corporation, not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231, nor to any insurance company subject to the tax imposed by section 243 or 246.

If, on June 30, 1922, or prior, a corporation formally decides to liquidate, no return need be made thereafter.

Period of doing business determines tax liability.[21]—

REGULATION. The tax being payable in advance does not apply to any corporation which was not engaged in business during any part of the fiscal year preceding the year for which the tax is due, but if it was in business even one day of the preceding year and one day of the taxable year it is subject to the tax. There is no relation between the amount of the tax payable and the length of time the corporation was in business. A corporation engaged in business during a part of the preceding year, but not engaged in business at the beginning of the taxable year, is not required to make any return if it is dissolved or in process of dissolution, but if it is only temporarily inactive and subsequently during the year reengages in business it should file a return in the month in which it recommences business and pay the tax due from the first of such month to the end of the taxable year. A corporation organized and beginning corporate activities on or after July 1 is not subject to tax for the remainder of the taxable period in which the company was organized, unless as of July 1, it takes over the business of an organization which was subject to capital stock tax, in which event the new corporation is required to file a return and pay the tax. In the case of foreign corporations "engaged in business," means the transaction of any business within the United States. (Reg. 50, revised, Art. 26.)

Exempt corporations.—In addition to corporations not "doing business" the thirteen classes of corporations enumerated in section 231 of the income tax law, and insurance com-

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[21] **[Former Procedure]**

"Doing business" by railroad corporation under federal control.—

REGULATION. "A corporation owning a railroad controlled and operated by the Government is exempt from liability for a given tax year only in case it does no business during such year. The liability of a corporation which actually does business is not affected by the control over its railroad exercised by the Government. . . . ." (Reg. 50, Art. 20.)

For detailed procedure regarding railroads, see Reg. 50, Arts. 20 and 21; T. D. 2800 (March 12, 1919); and T. D. 3156 (April 11, 1921).

panies (taxed under sections 243 or 246), are exempt. For details, see Chapter II.

Return by corporation claiming exemption.—

REGULATION. Where the officers of a corporation are of the opinion that it is exempt from the tax under section 231 of the Revenue Act of 1918, or on account of not being engaged in business, Form 707 (Revised) [Appendix B] should be filled out and filed with the collector, together with a comprehensive statement of the reasons for claiming exemption. In such case the fair value should be reported on page 1 of the form, but the tax not computed, notation "Exemption claimed" being made instead. If exemption has been allowed for the preceding taxable year and there has been no change in the status or conditions of the company then the first 14 lines of Form 707 (Revised) should be completed and a statement attached to the effect that exemption is claimed for the same reasons as for the previous year and that the same status and conditions of the company exist for the taxable period in question. In this way the records of the collectors' offices will be complete and corporations will avoid requests for the filing of returns and unnecessary correspondence. The determination of liability rests in the first instance with the Commissioner of Internal Revenue and without complete information it is impossible to make a decision. (Reg. 50, revised, Art. 28.)

Rate and Computation of Tax for Domestic Corporations

LAW. Section 1000. **(a) . . . . (1) Every domestic corporation shall pay annually a special excise tax. . . . . equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included; . . . .**[22]

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[22] [Former Procedure] Both the 1916 and 1918 laws imposed this tax on insurance companies.

1918 LAW. Section 1000. " . . . . (b) In computing the tax in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

"(c) . . . . and in the case of every such domestic [mutual insurance] company the tax shall be equivalent to $1 for each $1,000 of the excess over $5,000 of the sum of its surplus or contingent reserves maintained for the general use of the business and any reserves the net additions to which are included in net income under the provisions of Title II, as of the close of the preceding accounting period used by such company for purposes of making its income tax returns."

REGULATION. The tax is at the rate of $1 for each full $1,000 of the fair average value of the capital stock of the corporation in excess of the prescribed deduction of $5,000. The tax is computed not upon the par value of the stock, but upon the fair average value for the preceding year, or for the period during which it has been issued, if less than a year, of the capital stock outstanding at the date of the incidence of the tax. In the case of a domestic corporation it is on an entirely different basis from the excess profits tax, which is concerned with invested capital and not with the fair average value of the capital stock. Stock in the treasury of a corporation is not regarded as outstanding unless pledged as security for a debt. No deduction is allowed corporations organized in the United States for capital invested outside of the United States. If the corporation is doing business it is taxed on its entire capital stock even though most of it may not be employed in the business. (Reg. 50, revised, Art. 13.)

The foregoing regulation states (negatively) that pledged treasury stock must be regarded as outstanding. The author is unable to follow this reasoning.

The net effect, apparently, is to increase the value of gross assets, but the net worth of a corporation does not increase proportionately to an increase in gross assets. Treasury stock is of value as collateral to the pledgee only for purposes of control or similar reason. Its value as collateral is nil if the corporation's indebtedness to a creditor is acknowledged.

Methods of ascertaining fair value.—

REGULATIONS. Every domestic corporation shall make return on Form 707 (Revised) regardless of the par value of its capital stock. Also see articles 28 and 33. The fair average[23] value of the capital stock of a corporation and the tax payable thereon shall be determined in accordance with the instructions in the form, which pro-

[23] Form 707 (revised 1919) calls for the total stock outstanding on the last day of the corporation's fiscal year. The law [section 1000 (a-1)], however, provides that the amount of the tax shall be computed on the basis of the "fair average value of its capital stock for the preceding year."

REGULATION. "If a corporation has increased or decreased its capital stock during the fiscal year, a statement should be attached to the back of the return setting forth the number of shares of stock outstanding each month, with the average fair value of the stock for that month, computed under one of the three cases." (T. D. 2503, June 25, 1917.)

vides in Exhibit A for the book or fair value of the assets, in Exhibit B for the market value of the shares, and in Exhibit C for the value of the capital stock based on the capitalized earnings. All the information called for must be given in every case where it is procurable. (Reg. 50, revised, Art. 31.)

The fair average value of the capital stock for the purpose of determining the amount of the capital stock tax must not be confused with the market value of the shares of stock where it may be necessary to determine such value under other provisions of the revenue laws. The fair average value of the capital stock, the statutory basis of the tax, is not necessarily the book value or the value based on prices realized in current sales of shares of stock or even the value, determined by capitalization of earnings, although it may be more directly dependent upon the last. It should usually be capable of appraisal by officers of the corporation having a special knowledge of the affairs of the corporation and general knowledge of the line of business in which it is engaged. Provision is accordingly made in Exhibit C of Form 707 (Revised) for the tentative determination of the fair value of the capital stock by capitalizing the net earnings of the corporation on a percentage basis fixed by its officers as fairly representing the conditions obtaining in the trade and in the locality. But such fair value . . . . must not be set at a sum less than the reconstructed book value shown by Exhibit A, unless the corporation is materially affected by extraordinary conditions which support a lower valuation. In any such case a full explanation must accompany the return. The Commissioner will estimate the fair value of the capital stock in cases regarded as involving any understatement or undervaluation. . . . . (Reg. 50, revised, Art. 14.)

The capital stock tax on domestic companies is measured by the fair value of the total capital stock, including the surplus and undivided profits, for the year preceding the taxable year, whether the conduct of the business is profitable or otherwise.[24]

Regulation. The surplus and undivided profits of a corporation must be included in estimating the fair average value of its capital stock. If the fair average value be determined from the book value, the surplus and undivided profits are included in the assets, if from sales, they are necessarily a factor in determining the market price, and if from net income, they are reflected to a greater or less extent in the earnings. (Reg. 50, revised, Art. 15.)

For the purpose of this tax the fair value of the entire

[24] Form 707, page 4, instructions (see Appendix).

capital stock of a going concern, regardless of stock ownership or the ability of individual stockholders to liquidate their holdings, is required. The sales prices for any number of shares of stock less than a majority interest are not necessarily indicative of the fair value of the entire capital stock. The capital invested, the nature of the business, the kind of assets (slow or quick turning), goodwill, franchises, earning capacity, etc., are important factors that affect the worth of enterprises and must be given due consideration in arriving at the fair value at any given date.[25]

The three exhibits, A, B and C, are provided to indicate the information desired and the manner in which it should be furnished. So far as adaptable these forms should be completed by taxpayers, but if they find it more convenient they may attach to this return their own statements, provided substantially the same information is furnished. In any event, taxpayers should attach any additional statements that will aid in a comprehensive understanding of the taxpayer's return, so that the Commissioner of Internal Revenue may more equitably determine the correctness of the fair value reported in item 15 on page 1 hereof.[26]

Exhibit A provides for adjusting any overstated or understated values contained in the taxpayer's books of account, and exhibit C provides for showing an adjusted income, which should be the actual operating income to be used for capitalizing on a percentage basis fixed by its officers as fairly representing conditions obtaining in the trade and in the locality. If the reconstructed book value shown by exhibit A or the market value shown by exhibit B is greater than the valuation returned by the taxpayer, a comprehensive statement showing any extraordinary conditions which are relied on in support of the valuation claimed must be submitted. In any case in which the fair value is understated the amount will be redetermined by the Commissioner.[27]

[25] Form 707, page 4, instruction 1.
[26] Form 707, page 4, instruction 3.
[27] Form 707, page 4, instruction 1.

It will be noted that the balance sheet to be furnished under exhibit A is as of the close of the year preceding the taxable year. Since such a balance sheet will not reflect the "average" book value for the year, especially when material changes have been made in either the assets or liabilities, additional statements which will reflect the desired value should be furnished.

The foregoing is a clear statement of corporations' rights under the law. Briefly stated, a corporation should follow this procedure:

Fill in the answers called for by exhibits A, B or C—any or all. If the result does not produce a fair value, additional statements supporting the value claimed to be fair should be prepared and attached to the form.[28] It is wholly unnecessary for a corporation to accede to an assessment which overestimates the "fair average value of its capital stock."

The exhibits called for in form 707 are described in the official instructions (page 4., form 707) as follows:

EXHIBIT A: CONDENSED BALANCE SHEET.—

Furnish under exhibit A a condensed balance sheet as of the closing date of the fiscal year given in item 7 on page 1 hereof.

"Books of account."—These columns must show the amounts as carried in the taxpayer's books of account.

"Fair value."—Refer to article 1 above, defining the value required, and in the event the columns "books of account" contain any overstated or understated values show herein the actual values.

"Difference."—These columns will show the difference between the columns "books of account" and "fair value." Any material differences must be explained in such manner as to enable the Commissioner of Internal Revenue to determine if they are proper and acceptable. For this purpose the differences shown herein need not be covered by corresponding adjustments in the taxpayers' books of account.

"Treasury stock"[29] *and "treasury bonds."*—In the event the tax-

[28] For comments on methods of arriving at fair value, see *Income Tax Procedure*, 1918, pages 628-654.

[29] In arriving at the fair value of a corporation's own stock, treasury stock should always be first deducted from the nominal amount outstanding. This greatly simplifies the calculation and prevents complications which develop when stock is worth either more or less than par.

payer holds in its treasury any of its own stock or bonds, advice must be furnished as to whether such stock and bonds are pledged or unpledged.

"Other assets" and "other liabilities."—If material amounts are shown, a comprehensive analysis of them must be attached.

"Profit and loss."—If the "profit and loss" balance is a debit the amount should be shown in red.

Exhibit A of form 707 calls for the deduction of treasury stock from the gross amount of capital stock so that the net outstanding stock is shown. This is the correct basis for valuation of the stock. Stock in the treasury has in effect been paid off so far as the former holders thereof are concerned. Therefore, only the stock still outstanding in the hands of stockholders represents capital actually employed in the business.

Why "advice must be furnished as to whether such (treasury) stock and bonds are pledged or unpledged" is not clear, since it can neither increase nor decrease the net outstanding stock, the fair value of which is the basis of the tax.[30]

It must be borne in mind that the tax is to be computed on the basis of "the fair average value of the capital stock for the preceding year." [Law, section 1000 (a-1).] If the book value of the shares is used as a proper measure for taxation, and if a net profit has been earned during the preceding year, the *average* value of each share will be less than the value at the end of the year.

A statement of net worth, prepared by adjusting book values to actual values, is of great service in ascertaining the fair value of corporate stock, but book value is only one factor.

It is, however, not always practicable to place a "fair value" on fixed assets; in fact it is usually impossible to assign any value to such assets other than the book value. Also, the value of manufactured or partly manufactured goods on hand is extremely difficult of determination, especially in the case of an unprofitable concern. The fair value of such goods at a

[30] See page 1538.

given date is certainly influenced by the profitableness or otherwise of the manufacturing operations.

Capital stock is not worth book value even when book values are adjusted, unless recent earnings produce an adequate return. In a vast majority of cases when earnings of one or more years are poor, there is a reflection of this unsatisfactory condition in the fair value of the capital stock. In such cases or when the earnings have fluctuated greatly or when the average annual earnings, capitalized at a proper rate, do not fully support the book value or the adjusted book value, it is quite evident that the real "fair value" is an amount less than the book value and possibly more than the capitalized income value, depending upon the character of the assets, i.e., quick or slow turning, liquid or otherwise, etc.

Buyers simply will not pay book value for the shares of a corporation unless a fair average annual return is being realized on such book value.

If a corporation reports that the fair average value of its capital stock is equal to the aggregate of capital stock and surplus when its average net earnings thereon for several preceding years have been less than 20 per cent, it is in effect placing a higher value on its fixed assets than has usually been found to be justified.

EXHIBIT B: QUOTATIONS OR OUTSIDE SALES PRICES.—

Furnish under exhibit B the prices quoted on a recognized stock exchange or on the New York curb, or the prices at which outside sales were made if the stock is not listed, for the period of 12 months ending with the close of the taxpayer's fiscal year as given in item 7 on page 1 hereof.

If the stock is listed the name of the exchange from which reported quotations are taken must be shown in the space provided therefor, and the prices reported will be the mean of the highest and of the lowest bid[31] price during each month, from which the average for the year will be obtained. If the taxpayer prefers, a schedule may be attached to this return showing the highest and

[31] This is a correct basis. Reg. 38, 1916, Art. 6 (a), called for averaging *highest* bid prices.

lowest bid price at which stock was quoted for each day of the year and the average obtained therefrom.

If the stock is not listed and outside sales have been made at prices known or determinable by the officers making this report, such prices will be reported herein. A statement of the number of shares involved and the conditions under which sales were made at other than exchange quotations must accompany this return. Sales to employees or directors for qualifying purposes, or sales which are restricted as to resale, or sales at prices otherwise specially influenced, will not be considered representative of the fair value of the entire capital stock and should not be included.

In the column "No. shares outstanding" should be shown the total number of shares outstanding at the close of each month. The average value per share will be determined as follows:

First. If no change occurred in the number of shares outstanding during the year, total the quotations or sales prices for the months reported and divide by the number of months in which quotations or sales prices are shown.

Second. If any change occurred in the number of shares outstanding during the year, total the quotations or sales prices for the months reported during which the number of shares outstanding at date of incidence of the tax has been outstanding and divide by the number of months used in the computation.

"Date of incidence of the tax" is July 1 of the taxable year.[32]

Exhibit C: Annual income.—

Furnish under exhibit C the annual income and other data for the five fiscal years ended with the close of the taxpayer's fiscal year as given in item 7 on page 1 hereof, or for the period during which the corporation has been engaged in business if for a shorter period.

"Net income."—In this column will be shown the income returned for the purpose of the income tax and excess profits tax.

"Deductions" and "additions."—Refer to article 1 of these special instructions, and show in these columns such amounts as should be deducted from or added to "net income" to arrive at the adjusted income which may be capitalized to determine the fair value of the

[32] [Former Procedure] Form 707 for tax year July 1, 1919, to June 30, 1920, provided:

"If any change occurred in the number of shares outstanding during the year, calculate the total value of the outstanding shares each month upon the reported prices and divide the total of such monthly valuations by the sum of the number of shares outstanding each month."

The former regulation is sound but it is doubtful if the present regulation is equitable.

capital stock. A comprehensive analysis of any amounts reported therein should be attached to this return. Some of the principal items frequently requiring adjustment follow:

Deductions:
- Income and profits taxes not deductible in computing income subject to tax.
- Depreciation and depletion.
- Interest charges not deductible in computing income subject to tax.
- Losses not fully deductible in computing income subject to tax.

Additions:
- Dividends from other corporations not included in computing income subject to tax.
- Income from securities of a state, municipality, or of the United States, not included in the income tax return.
- Expenditures made for additions and betterments, or reserves for such purposes, made against income whether direct or through expenses.

"Adjusted income."—This column will reflect the amounts resulting from adjustment of amounts shown in three preceding columns.

"Number shares."—Herein should be given total number of shares of all classes of stock outstanding at close of each fiscal year.

"Dividends declared."—Herein should be reported the percentage of dividends declared on the par value of each class of stock outstanding each year. The amount represented by the percentages shown in this column must not be deducted from the columns "net income" or "adjusted income."

"Depreciation."—Hereunder will be reported the amount actually charged against income each year in the taxpayer's books of account for depreciation.

"Depletion."—In the case of mines, oil and gas wells, other natural deposits, and timber, valuations reported as the basis of depletion in computing Federal income and profits taxes should be shown in the "Fair value" column [of Exhibit A].

Capitalizing net income.—The officers making the return will capitalize the average annual income on a percentage basis that fairly represents the conditions obtaining in the trade in the locality that representative enterprises must earn in order to maintain their stock at par. In other words, if enterprises engaged in a similar business must on the average earn 12 per cent on their issued capital stock to keep the value of their stock at par, the net income should be capitalized by dividing it by .12.

Some of the best stocks in this country, which are valued for the purpose of this tax at their average quotations on the

New York Stock Exchange (a fair basis in many cases, as the sales are numerous and actual transactions between willing buyer and willing seller are after all the best indication of value) have during recent years shown 30, 40 or even 50 per cent per annum earned on their par value, though their selling prices in the open market have often not been above par.

An industrial stock to be valued at par should have net tangible assets equal to par, unless the average earnings exceed 20 per cent per annum on the capital stock.

If the earnings are considerably above 20 per cent per annum, fair value may be more than par, but the physical assets must always be considered. If earnings are on a downward trend, the average may be disregarded. Only in exceptional cases should the item of goodwill be a factor in valuations under this act. If the goodwill actually has a present value, it will be reflected in the earnings shown in exhibit C.

An excise tax imposed on the privilege of doing business as a corporation should be construed in favor of the taxpayer, and speculative values and other items which sometimes influence high prices for shares should be ignored.

In considering earnings as a basis for valuation, it should be remembered that if the earnings include unusual profits, which it is not expected will recur periodically, a prospective purchaser of the stock would not pay a price based on capitalizing such extraordinary profits. Unless exhibit A supports the capitalized value of profits of an unusual nature, it would be fallacious to capitalize them for valuation purposes.

Income and excess profits taxes should be deducted before earnings are capitalized for the purposes of the excise tax.

When net profits of past years are used in calculating average earnings, net losses must also be used in the computation.

Issuance of new stock does not affect average income capitalized.—

Ruling. Should adjustment be made in determining average income under Exhibit C, when capital increased from ten thousand to fifty thousand in nineteen nineteen?

(Answer.) Your wire twenty-sixth. Disregard number shares outstanding when capitalizing net income, Exhibit C of Form 707. (Telegram of inquiry from Morris F. Frey, the Guaranty Trust Company, New York, N. Y., and the reply thereto signed by Deputy Commissioner James Hagerman, Jr., and dated July 27, 1920.)

Preferred and common stock.—Since many corporations have more than one class of stock, provision must be made for a calculation which gives due weight to the fair value of the entire outstanding capitalization. It is believed that a short and simple rule will settle any apparent difficulties in determining a proper valuation.

As to preferred stock.—If preferred stock has a market value, the actual number of shares of preferred stock outstanding multiplied by the average market value of each share will produce the desired result. If preferred stock has no market value, but if its book value is in excess of par, and if some value is ascribed to the common stock, the preferred stock should be listed at par.

There are, however, many classes of preferred stocks. When there is no cumulative provision as to dividends; no, or only partial, preference as to assets; a low rate of dividend, or other factors which, as compared with similar preferred stocks *having* a market value, would tend to lower the fair value of the preferred stock, full weight must be given to all factors and that value must be placed upon each share of preferred stock which can be supported as being a fair value.

As to common stock.—If it be borne in mind that the one base of the tax is the *net worth* of the corporation, it will simplify the calculations whenever more than one class of stock is concerned. In all cases (exclusive, of course, of corporations the market value of whose shares can be ascertained) the fair value of a corporation's entire capitalization will have to be determined. This should be done regardless of the different classes of shares, if any. After a trustworthy estimate has been made, the aggregate valuation placed upon the one

or more classes of preferred stock should be deducted; the balance represents the proper valuation for the common stock.

Deductions and Credits

LAW. Section 1000. **(a) (1) . . . . a . . . . tax . . . . equivalent to . . . . so much of the fair average of its capital stock . . . . as is in excess of $5,000. . . . .**

Corporation must file return even though the fair average value of its stock does not exceed $5,000.—

REGULATION. From the total fair average value of the capital stock the sum of $5,000[33] is to be deducted, and the tax is upon each full $1,000 of any balance. Accordingly, corporations the fair average value of whose capital stock is not more than $5,000 are not subject to tax, but for the purpose of avoiding error every corporation is required to file a return as directed in article 31. (Reg. 50, revised, Art. 16.)

Returns

Time of making returns.—

REGULATION. It shall be the duty of every corporation liable to the tax on or before the 31st day of July in each year to make a return, verified by oath, to the collector of the district in which its principal place of business is located. If any corporation fails to make and file a return within the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return, the collector or deputy collector shall make the return from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony, or otherwise, make a return or amend any return made by a collector or deputy collector. Any return so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes. If on account of sickness or absence of the officer of the corporation charged with making the return, it is impossible to prepare and file a return on or before the 31st day of July (the due date), the collector, upon application in writing, may allow an extension of time not exceeding 30 days from July 31, in which to file the return. If extension is granted, the letter of the collector should be attached

[33] Prior to July 1, 1918, the exemption was $99,000.

to the return. On no account is the Commissioner of Internal Revenue or the collector authorized to grant an extension of time in which to file capital stock returns in excess of 30 days from July 31, the due date. If for reasons, other than absence or sickness, beyond the control of the officers making the return, it becomes impossible to file a completed return within the time prescribed by law, a tentative return may be filed, thus avoiding penalty for failure to file within the prescribed time. See following article. (Reg. 50, revised, Art. 33.)

Tentative return.—

REGULATION. The filing of a tentative return will avoid the penalty for delinquent filing, but does not authorize the withholding of the tax. The regulations do not permit the filing of a tentative return to stay indefinitely the filing of a completed return and the collection of the tax due; therefore, a tentative return clearly marked "Tentative return" should be prepared in as complete a manner as possible, including, among other information, a basis for the computation of the tax—that is, an estimate by the officers of the corporation of the approximate fair value of the capital stock in order that an initial assessment may be made. When the completed return is filed, it should be clearly marked "Completed return," showing that a tentative return was filed. Such action will prevent duplicate assessments and ordinary penalties. In every case a statement should be attached to the tentative return, indicating the approximate date the completed return may be expected. Upon receipt of the completed return any adjustment necessary in the assessment of the correct tax due will be made. (Reg. 50, revised, Art. 34.)

When return must be filed before information is available.—

RULING. Answering your letter of July 3, 1919, in which you make inquiry as follows:

> "What is the best procedure for reporting net income under exhibit C of capital stock tax returns, form 707, in the case of corporations whose fiscal year ends June 30, and who have not filed return for Federal income tax purposes before the time for filing capital stock tax returns has expired?"

you are advised paragraph 3, special instructions 1, page 4, form 707, states:

" . . . . and the taxpayer will complete each exhibit or state why the required data are not available."

The law provides that capital stock tax returns shall be filed during the month of July for the taxable period beginning July 1 and that the collector is empowered to grant an extension of thirty days

beyond the due date of filing only in case of sickness or absence of the officer charged with the preparation of the return. You will therefore note there is no authority under the law for granting an extension for any reason beyond thirty days from July 31, 1919.

Capital stock tax returns should therefore be completed so far as practicable and filed with the collectors within the prescribed time with the statement that unavailable data will be furnished in a supplemental report at the earliest possible date.

In the case of any failure to make and file a return within the prescribed time a penalty of 25 per centum of the amount of the tax attaches, except that when the failure to file was due to a reasonable cause and not to willful neglect no such addition shall be made to the tax.

The above procedure will avoid any assertion of the penalty or question as to what constitutes a reasonable cause. (Letter to The Corporation Trust Company, signed by Deputy Commissioner J. Hagerman, and dated July 11, 1919.)

The law should be amended to provide ample time within which to file accurate returns.

Affiliated corporations, returns of.—

REGULATION. Although section 240 of the Revenue Act of 1918 requires a consolidated return for affiliated corporations for the purpose of income tax[34] for the purpose of capital stock tax each corporation must render a separate return in complete form. So-called subsidiary corporations, all or a part of the stock of which is owned by another corporation, must render separate returns, the same as every other corporation. No deductions from the assets are permitted on account of inter-company balances, and the shareholdings must be reported in the "Fair value" column at their actual worth at the time of making the return. No deduction is allowed in the return of one corporation for the tax paid by another. If the fair value is determined by any method other than herein provided, the following requirements must be complied with: (a) The parent company must submit with its return a list of all subsidiaries and the districts in which the returns were filed; (b) the return of the subsidiary company must show the name of the parent company and the district in which the return was filed; (c) the method of determining the fair value, if other than by Exhibits A, B, and C, must be fully explained; (d) a copy of any agreement existing between parent company and subsidiary must be furnished, or a statement made that none exists; and (e) a combined balance sheet and a combined net

[34] The 1921 law provides for filing either consolidated or separate income tax returns for tax years beginning on or after January 1, 1922. This change will have no effect on the capital stock tax returns.

income statement must be submitted for consideration in connection with any estimate of fair value made on behalf of the reporting corporation. (Reg. 50, revised, Art. 35.)

RULINGS. In reply to your letter of May 17, 1919, requesting an interpretation of article 106 of Regulations 50,[35] regarding capital stock tax returns required of affiliated corporations, you are advised that the sentence, "If the fair value of its capital stock is based upon a consolidated report, a copy of such report should be attached to the capital stock tax return of each affiliated corporation," refers to each corporation of an affiliated group, that is, the parent company as well as each subsidiary.

Article 101, Regulations 50,[36] requires every domestic corporation to file a return regardless of the par value of its capital stock unless specifically exempt under section 231.[37] An exemption of $5,000 is allowed.

In many cases, as for instance, in the case of selling agencies separate corporations are formed in order properly to handle certain business under various state laws and in reality are branches or departments of the parent corporation. The business is controlled by the parent corporation and the result of operations is a matter of bookkeeping.

The capital stock tax being imposed upon the fair value of the capital stock of corporations it makes little difference by what method such fair value is determined. Therefore, if affiliated corporations are best able to determine the fair value of the respective companies through a consolidated report such privilege is permitted by the Department, but it seems preferable to leave this to the corporations interested subject to approval by the Commissioner of Internal Revenue rather than attempt to outline a specific method that would apply to all. (Letter to The Corporation Trust Company, signed by Deputy Commissioner J. Hagerman, and dated June 2, 1919.)

Referring to office letter of June 2, 1919, it has come to the attention of this office that a number of taxpayers are construing this letter as granting special privileges not intended and not permitted under the law and regulations. This letter properly interpreted reflects the views of this office and is applicable to such cases. The taxpayers, however, may have been misled by the wording of the heading, which reads:

"Consolidated Returns of Affiliated Corporations"

and it is suggested with a view to avoiding further misunderstanding that the heading be revised, as follows:

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[35] Art. 35 of Reg. 50, revised, is substantially the same.
[36] Art. 33 of Reg. 50, revised.
[37] The 1921 law also exempts from this tax insurance companies taxable under section 243 or 246.

"Returns of Affiliated Corporations based upon a Consolidated Report."

The difficulty of outlining a general ruling that covers all questions relating to affiliated corporations should be appreciated and the taxpayer must realize that the tax is imposed upon the fair value of the capital stock of each individual corporation as disclosed by the facts in a given case, regardless of corporate affiliations. Only under certain conditions are corporations permitted to arrive at the fair value of the capital stock of the respective companies through a consolidated report, that is, where the fair value cannot be determined independently.

In interpreting the letter above mentioned, distinction must be drawn between the word "return" and the word "report." Under all circumstances individual returns are required of every corporation regardless of the basis used in arriving at the fair value. (Letter to The Corporation Trust Company, signed by Deputy Commissioner J. Hagerman, and dated November 11, 1919.)[38]

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[38] **[Former Procedure]**

Additional returns for taxable year ended June 30, 1919, when required on account of retroactive features of law.—

Regulation. "Under the Revenue Act of 1916 the time for filing capital stock tax returns for the fiscal year ending June 30, 1919, was extended to September 30, 1918, and in the case of Hawaii to October 31, 1918. Any corporation which failed to file a return for such fiscal year for the former tax, whether or not it was liable thereto, must file a return for such fiscal year under the present statute before June 1, 1919. . . . . Where returns were filed for the fiscal year ending June 30, 1919, such returns will be used so far as practicable in making the additional or original assessments for such taxable period. In the case of domestic and foreign mutual insurance companies, the new basis for the tax will necessitate supplemental statements, which should be furnished upon request. For the taxable period July 1, 1918, to June 30, 1919, letters will be forwarded to taxpayers showing how the original or additional assessment has been determined, in order that the collector's bill when presented may be understood and payment promptly made. . . . ." (Reg. 50, Art. 105.)

As previously stated, the provisions of the 1918 law were made retroactive to July 1, 1918. Formerly some corporations were not required to file returns, but due to the small exemption provided by the 1918 law the Treasury decided to require returns from all corporations beginning with returns for the taxable year July 1, 1918, to June 30, 1919. Returns made necessary by the new regulations of the Treasury were due before June 1, 1919. So far as practicable the tax at the increased rate, after giving effect to the reduced exemption for the year ended June 30, 1919, was computed by the Treasury from information contained in the returns previously filed.

Payments[39]

Time of payment of tax.—The tax is assessed annually in advance.[40]

Decision. The capital stock tax imposed by the Act of September 8, 1916, is not illegal because assessed and collected in advance under regulations of the Treasury Department, the act, by sections 407 and 409, contemplating that a corporation must pay a tax on its capital stock for the preceding year in order to do business for the coming year.

Regulation. All assessments shall be made by the Commissioner. The collector shall within 10 days after receiving any list of taxes from the Commissioner give notice to each corporation liable to pay any tax stated therein, to be left at its place of business or to be sent by mail, stating the amount of such tax and demanding payment thereof. If such corporation does not pay the tax within 10 days after the service or the sending by mail of such notice, it shall be the duty of the collector to collect the tax with a penalty of 5 per cent additional upon the amount of the tax and interest at the rate of 1 per cent a month. A collector has no authority to extend the time for payment of the tax, and any extension granted by him will be at his own risk. All taxes are payable direct to the collector of internal revenue of the district in which return is filed. The collector may accept payment of the tax when the return is filed as an "advance collection," subject to any adjustment later found necessary, but no corporation is required to pay the tax until after notice and demand. Tax due from a corporation is legally collectible from the stockholders or others who have received its assets upon liquidation. (Reg. 50, revised, Art. 36.)

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[39] **[Former Procedure]**

Tax paid under former law, credit for.—

Regulation. "Where a corporation has paid the tax for the fiscal year July 1, 1918, to June 30, 1919, under the Revenue Act of 1916, the amount so paid may be credited against the tax imposed by the present statute for such period and only the excess of the tax over such amount will be collected. For the rates of the former tax and its other provisions see Reg. 38 (revised). Because of the reduction of the exemption from $99,000 to $5,000 in the case of domestic corporations and of the abolition of any exemption in the case of foreign corporations, many corporations must now pay the tax which were formerly exempt. . . . ." (Reg. 50, Art. 81.)

[40] *Washington Water Power Co. v. U. S.* (not yet reported), U. S. Court of Claims, February 14, 1921. (T. D. 3160).

Penalties

Failure to pay.—

REGULATION. (a) Any corporation which fails to pay the tax when due and payable is liable to a penalty of $1,000. If it willfully refuses to pay or willfully attempts to evade the tax, it is liable also to a fine of $10,000.00 and costs and to a 100 per cent penalty to be added to the tax. See also article 41. (b) Any officer or employee of a corporation who in the course of his duty fails to pay the tax when due and payable is liable to a penalty of $1,000. If he willfully refuses to pay or willfully attempts to evade the tax, he is liable also to a fine of $10,000 and costs and to imprisonment for a year, and to a penalty of the amount of the tax unpaid or evaded. (Reg. 50, revised, Art. 42.)

It is to be noted that the specific penalties of $1,000 and $10,000 are additional to the 5 per cent penalty and 1 per cent per month interest penalty referred to in article 36. (See page 1553)

Failure to make return and penalty for false return.—

REGULATION. (a) Any corporation which fails to make a return within the required time is liable to a penalty of $1,000. If it willfully refuses to make a return it is liable also to a fine of $10,000 and costs. (b) Any officer or employee of a corporation who in the course of his duty fails to make a return within the required time is liable to a penalty of $1,000. If he willfully refuses to make a return he is liable also to a fine of $10,000 and costs and to imprisonment for a year. (c) Section 3176 of the Revised Statutes,[41] as amended by section 1317 of the Revenue Act of 1918, also provides:

In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 percentum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 percentum of its amount.

The amount so added to any tax shall be collected at the same

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[41] Section 1311 of the 1921 law re-enacts section 3176, Rev. Stat., as amended by the 1918 law.

time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity or fraud, in which case the amount so added shall be collected in the same manner as the tax. (Reg. 50, revised, Art. 43.)

Doing business without payment of tax.—

REGULATION. Every corporation which does business without having paid the tax is liable to a penalty of $1,000. A corporation paying the capital stock tax is not on that account exempt from any occupational tax. For other penalties see articles 42 and 43. (Reg. 50, revised, Art. 41.)

Foreign Corporations

LAW. Section 1000. (a) . . . . (2) **Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June thirtieth. . . . .**

Definition of foreign corporation.—

REGULATION. A foreign corporation is a corporation created or organized outside the United States as defined in Article 8.[42] (Reg. 50, revised, Art. 9.)

Scope of tax.—

REGULATION. The basis of the tax in the case of a foreign corporation is "carrying on or doing business in the United States." A foreign corporation is carrying on or doing business in the United States if it maintains an agent or an office or warehouse in the United States, or, in the case of an insurance company, if it writes insurance policies here, or in any other way enters the United States for the purposes of its business. The purchase of supplies in the United States in the furtherance of continued efforts in the pursuit of profit or gain is carrying on or doing business in the United States. (Reg. 50, revised, Art. 17.)

It may be assumed that the term "doing business" as applied to the activities of a foreign corporation in the United States, will be interpreted in the same manner as when applied to a domestic corporation doing business in another state.

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[42] See page 1529.

If so, the mere purchase of supplies does not constitute "doing business."[43]

Rate of tax.—

REGULATION. The tax is at the rate of $1 for each full $1,000 of the capital of a foreign corporation actually employed[44] in the transaction of its business in the United States, and is in all cases to be computed on the basis of the average amount of capital so employed during the preceding year ending June 30. The measure of the tax is accordingly different from that in the case of domestic corporations which pay a tax measured by the fair average value of their capital stock. No deduction from the total fair average amount of capital so employed is allowed in computing the tax. (Reg. 50, revised, Art. 20.)

Capital "employed" in the United States.—

REGULATION. The "capital employed in the transaction of its business in the United States" means the portion of the total capital, surplus, and undivided profits, of the foreign corporation, utilized for the purpose of doing business in the United States. A foreign corporation may have income from sources within the United States for the purpose of the income tax, and yet not have capital employed in the transaction of business here for the purpose of the capital stock tax. Compare articles 91-93 and 550 of Regulations 45. A foreign corporation not actually doing business in the United States is not subject to tax, and accordingly the investment of a part of its funds in United States stocks and securities will not constitute capital employed in its business in the United States. For the definition of "doing business" see article 10.[45] If a corporation does business here, then, although the mere investment of funds in United States securities is not such a taxable employment of capital, such investment will constitute capital employed in the transaction of business in the United States, if made in a subsidiary corporation which the foreign corporation uses as an instrumentality for the successful conduct of its own business in the United States. Thus the investment of the funds of a foreign corporation in the purchase of facilities, although apparently independent, for the purpose of its business here, or the purchase of stock and securities of a subsidiary corporation for the same purpose, will constitute the employment of capital in the transaction of business in the United States. A foreign corporation may not escape taxation by organizing, or purchasing

[43] See page 1533.
[44] The word "invested" was used in the 1916 law.
[45] See page 1533.

the stock of another corporation to own the facilities which the foreign corporation needs in its business. See article 352, Regulations 45. (Reg. 50, revised, Art. 18.)

If the foreign corporation does no business whatever in the United States, a separate domestic corporation being utilized for the carrying on of business in this country, it is obvious that the law imposes the capital stock tax only on the subsidiary. The mere ownership of the stock of an American corporation by a foreign corporation does not of itself constitute doing business by the latter in the United States.

"Capital 'employed' in the United States" illustrated.—

REGULATION. A foreign corporation may employ capital in the transaction of its business in the United States in various ways. For example, the investment of funds in property in the United States used in its business, in stocks and securities of subsidiary corporations as explained in article 18, in bills and accounts receivable representing business done in the United States, in merchandise kept here for sale, in materials manufactured here, and in deposits in United States banks maintained for use in business here. Generally speaking, approximately such proportion of the entire capital of a foreign corporation will presumably be employed in the transaction of its business in the United States as the gross amount of its business in the United States bears to its total gross business, but this will not always be true, since a corporation may conceivably transact a greater or less volume of business in one country than in another on the same amount of capital. (Reg. 50, revised, Art. 19.)

Basis of tax, foreign corporation.—

REGULATION. The measure of the tax is the average amount of capital employed in the transaction of business in the United States during the preceding fiscal year. It will usually be sufficient to determine the amount of capital so employed at the beginning of each year and the amount so employed at the end of such year, and to divide the sum of such amounts by two. Where, however, there have been material changes in the amount of capital, the average amount should be determined with due regard to the times at which such changes occurred. A foreign corporation may, if it so desire, compute the average amount of capital employed on a monthly basis. (Reg. 50, revised, Art. 21.)

Capital "employed" includes borrowed capital.—

RULING. Following question submitted on behalf our client the ——— Company, a foreign corporation. Referring Article 33 [Art. 18], Reg. 50, is capital stock tax to be computed on entire amount of capital employed in this country irrespective of whether that capital consists in part of company's own capital and in part of borrowed capital? Kindly wire reply collect.

(Answer.) Your wire 25th. Capital stock tax is imposed upon capital employed irrespective of its nature whether borrowed, paid in or earned. (Telegram of inquiry from E. G. Shorrock & Co., Seattle, Washington, and the reply thereto, signed by Deputy Commissioner J. Hagerman, and dated October 30, 1919.)

Form 708, which provides for determining the capital employed in the United States by a foreign corporation, calls for a statement of the total capital, surplus and undivided profits (whether employed within or without the United States) and a statement of the assets employed in the transaction of business in the United States. The latter statement makes no provision for deducting liabilities incident to the transaction of business in the United States. In the case of a foreign corporation all of whose capital was employed in the United States, this would lead to the absurd result of showing a larger amount of capital employed in the United States than its actual total capital. Of course, if the corporation had absolutely no liabilities the result would be the same in both statements; but as practically all corporations have liabilities, proper deduction should be made from the United States assets for the liabilities incident to the business in this country.

Return by foreign corporations.—

REGULATION. Every foreign corporation carrying on or doing business in the United States shall make return on Form 708 (Revised) irrespective of the amount of capital employed in this country in the transaction of its business. The capital actually employed in the transaction of the business of a foreign corporation in the United States and the tax payable thereon shall be calculated in accordance with the instructions on the form.[46] See also articles 17, 18, 19, 20 and 21. (Reg. 50, revised, Art. 32.)

[46] See Appendix B.

Inspection of Returns

Regulation. The returns upon which the tax has been determined by the Commissioner, although public records, are in general open to inspection only to the extent authorized by the President. All bona fide stockholders of record owning 1 per cent or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporations and of its subsidiaries, but such privilege of examination is personal and can not by power of attorney be delegated by the stockholder to another. Only such officers of any State as are charged with the enforcement of a State income-tax law shall have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe, and then only in case the information is to be used by them in connection with such enforcement. Any stockholder who is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding 1 year, or both. (Reg. 50, revised, Art. 30.)

Section 257 of the law, which referred specifically to income tax returns and on which the foregoing regulation is based, was by section 1000 (c) also made applicable to capital stock tax returns.

Abatement and Refund of Taxes

Regulation. Section 3220. of the Revised Statutes, as amended by section 1316 of the Revenue Act of 1918 [re-enacted without change as section 1315 after 1921 law] provides:

Section 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal-revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him

by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section.

Section 3225 of the Revised Statutes, as amended by section 1316 of the Revenue Act of 1918 [re-enacted without change as section 1323 of the 1921 law], however, provides:

Section 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded or paid back or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation.

For the procedure regarding claims for abatement or refund, see Regulations 14 (Revised). (Reg. 50, revised, Art. 37.)

Medium of Payment of Tax

Regulation. Collectors may accept uncertified checks in payment of taxes, provided such checks are collectible at par—that is, for their full amount, without any deduction for exchange or other charges. The collector will stamp on the face of each check before deposit the words, "This check is in payment of an obligation to the United States and must be paid at par. No protest," with his name and title. The day on which the collector receives the check will be considered the date of payment so far as the taxpayer is concerned, unless the check is returned dishonored. If one check is remitted to cover the taxes of two or more corporations, the remittance must be accompanied by a letter of transmittal stating (a) the name of the drawer of the check; (b) the amount of the check; (c) the amount of any cash, money order, or other instrument included in the same remittance; (d) the name of each corporation whose tax is paid by the remittance; (e) the amount of the payment on account of each corporation; and (f) the kind of tax paid. (Reg. 50, revised, Art 39.)

Dishonored checks, procedure.—

Regulation. If the bank on which any such check is drawn shall refuse to pay it at par, the check shall be returned through the depositary bank and be treated in the same manner as a bad check. All expenses incident to the attempt to collect such a check and the return of it through the depositary bank must be paid by the drawer of the check to the bank on which it is drawn, since no deduction can be made from amounts received in payment of taxes. See section 3210

of the Revised Statutes. If any taxpayer whose check has been returned uncollected by the depositary bank shall fail at once to make the check good, the collector shall proceed to collect the tax as though no check had been given. A taxpayer who tenders a certified check in payment for taxes is not released from his obligation until the check has been paid. See chapter 191 of the act of March 2, 1911. (Reg. 50, revised, Art. 40.)

Credit of Munition Manufacturer's Tax

REGULATION. From the tax payable as above determined the amount, if any, of the munition manufacturer's tax imposed by Title III of the Act of September 8, 1916 (no longer in effect since January 1, 1918), actually paid by the corporation since making its last previous return hereunder is deductible. If a munition manufacturer's tax is due and payable but has not been paid at the time the capital stock tax becomes due and payable no credit of the munition manufacturer's tax is permissible, until after the munition manufacturer's tax has been paid. After it has been paid the credit may be availed of by a claim for the refund of so much of the capital stock tax actually paid as is not in excess of the munition manufacturer's tax which became due and payable within the same calendar year. (T. D. 3009, signed by Commissioner Wm. M. Williams, and dated April 22, 1920.) (Reg. 50, revised, Art. 10.)

Election to be taxed as corporation.—The 1921 law[47] provides that in the case of the organization as a corporation, within four months of the passage of the act, of any trade or business in which capital is a material income-producing factor and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921 (if it was not less than 20 per cent of its invested capital), may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under the income and excess profits taxes.[48] The invested capital and net income

[47] Section 229.

[48] **[Former Procedure]**

Election to be taxed as corporation.—

REGULATION. A business enterprise (a) which was organized as a corporation before July 1, 1919, (b) in which capital is and has been a material income-producing factor, and (c) which was previously owned by a partnership or individual, may elect to be taxed as a corporation on its net income from January 1, 1918, to the date of organization of the corporation. In such event the corporation shall be treated as if in existence

shall be computed in the same manner as they would be determined if the corporation had been in existence on January 1, 1921. All other provisions of law with respect to tax on corporations are made effective as of January 1, 1921. It is specifically provided that any taxpayer who takes advantage of this provision shall pay the capital stock tax imposed by the 1918 law, commencing with January 1, 1921.

Under the 1918 law, a corporation commencing business January 1, 1921, would pay capital stock tax from July 1, 1921. The intention is fairly clear that the capital stock tax is to be paid for the first six months of 1921, but the language is not. In this respect the law differs from the provisions concerning personal service corporations as to which no intention to tax from January 1, 1922, can be found.

Final determination and assessment.—Section 1312 of the 1921 law permits of an agreement in writing between the taxpayer and the Commissioner with respect to the amount of tax liability. It is provided that when such agreement is entered into, the case shall not be reopened by either the government or the taxpayer and no suit to overthrow it shall be entertained by any court, except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination of the tax liability.[49]

This is a reasonable and wise provision of law. It will, however, undoubtedly be more beneficial with respect to taxes

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since January 1, 1918, for the purposes of the income tax, the war profits and excess profits tax, and the capital stock tax. The adoption of any other date than January 1, 1918, for such purpose is not permissible. But this option is not extended to a business enterprise with a net income for the taxable year 1918 less than 20 per cent of its invested capital.

The clauses of section 407, Revenue Act of 1916, as amended, and section 1000, Revenue Act of 1918, which require that a corporation must have been engaged in business some part of a year preceding the taxable period in order to be liable for the tax, are not applicable to corporations filing returns under section 330 of the Revenue Act of 1918; that is to say, organizations electing to report as corporations under the provisions of this section, are required to file capital stock tax returns for the six months' period from January 1 to June 30, 1918, and for all subsequent taxable periods. (Reg. 50, revised, Art. 29.)

[49] See page 210.

other than the capital stock tax. The section of the Bureau handling this tax is on a fairly current basis and, so far as the author knows, cases in the capital stock tax section are not reopened as frequently as in some other sections of the Bureau.

Treasury decisions not necessarily retroactive.—Section 1314 of the 1921 law provides that Treasury decisions or rulings of the Commissioner or the Secretary which are not immediately occasioned or required by a decision of a court of competent jurisdiction, are not necessarily retroactive in effect. The question of retroactive appliance of such rulings is left to the discretion of the Commissioner with the approval of the Secretary.

Limitations upon additional assessments and refunds.—Section 1322 provides that, notwithstanding the provisions of section 3182 of the Revised Statutes, assessments of additional taxes must be made within four years after such taxes become due. This provision applies only in the absence of fraud or an attempt to evade tax. In the latter case, assessment may be made at any time.

This section became effective upon the passage of the 1921 law, November 23, 1921, and, as it modifies the limitation in section 3182, Revised Statutes, additional assessments of capital stock tax for the tax period beginning July 1, 1918, may be made at any time before July 31, 1922.

Section 1316 of the 1921 law amends section 3228, Revised Statutes,[60] and provides for the filing of claims for refund of taxes erroneously or illegally assessed or collected at any time within four years next after payment of such tax.

Limitation upon suits.—Section 1320 of the 1921 law provides that no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five

[60] See Chapter IX.

years from the time such tax was due, except in the case of fraud.[51] Suits begun prior to the passage of the 1921 law are not affected by this limitation.

Limitation of criminal prosecution.—Section 1321 of the 1921 law amends the Act of July 5, 1884, and provides that no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information is instituted within three years of the commission of the offense. This provision became effective with the passage of the 1921 law on November 23, 1921.

Interest on refunds and judgments.—Section 1324 provides, with certain limitations, for the payment of interest by the government on refunds and judgments.[52]

Unnecessary examinations.—Section 1309[53] of the 1921 law provides that taxpayers shall not be subject to unnecessary examinations or investigations. Only one inspection of the taxpayer's books of account shall be made for each taxable year, unless the taxpayer requests otherwise, or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional investigation is necessary.

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[51] See Chapter VIII.
[52] See Chapter IX.
[53] See page 115.

[FormerProcedure]

Credit for munition manufacturers' tax.—Section 407 of the 1916 law provided for a credit of the munition manufacturers' tax actually paid against the capital stock tax under certain conditions. The Treasury at first construed this section literally and disallowed claims for refund where the capital stock tax became due and payable before the munitions tax in the same calendar year. T. D. 3009, dated April 20, 1920, reversed this procedure and permitted claims for refund to be filed. This Treasury decision was intended to validate prior claims, but section 3228, Revised Statutes, as it then read, limited the period of claim to two years. Had taxpayers followed the law and not the regulations, the claims would have been in order.

Section 3228, Revised Statutes, has been revised by the 1921 law (section 1326) and extends the limitation period to four years, applying the change to claims submitted under the 1916, 1917, 1918 and 1921 laws. Unless the right to claim accrued before November 23, 1917, they are barred and the revision of section 3228, Revised Statutes, is of no benefit.

APPENDIX A

SUPPLEMENT TO EXCESS PROFITS TAX PROCEDURE 1921

The material contained in this appendix is provided for the purpose of bringing up to date *Excess Profits Tax Procedure,* 1921. The appendix is divided into chapters corresponding to those of the 1921 book, and all comments and rulings are preceded by a page reference. It is thought that by this means, the reader will be enabled to bring up to date his copy of *Excess Profits Tax Procedure,* 1921.

CHAPTER I

INTRODUCTION (AND FAREWELL)

The excess profits tax law became effective January 1, 1917; it became inoperative December 31, 1921. It was conceived in the necessities of the war. It has been called illegitimate (certainly no one claims the distinction of being its father) but the United States Supreme Court has thrown the protection of the Constitution around it. *It had no friends;* but it raised more money than any other tax measure in the history of the world. Why not let it die in peace? If we do not, the agricultural bloc will revive it to raise the money for the soldiers' bonus.

CHAPTER II

ADMINISTRATION AND APPLICATION OF THE LAW

Page 12

Administration.—The excess profits tax section of the law is administered by the Commissioner in the same manner as is the income tax law.

Changes in administrative procedure during 1921 are fully discussed in Chapter VII of this book.

Page 14

Types of corporations subject to the tax.—Aside from adding a few corporations to the exempt list,[1] the new law does not change the applicability of the excess profits tax law. A change has been made in case of the income of foreign cor-

[1] Section 231, see page 34 *et seq.*

porations engaged in shipping[2] and in case of domestic corporations which derive the major part of their income from the possessions of the United States.[3]

CHAPTER III

EXEMPTIONS

The 1921 law makes the following changes in the provisions which govern exemption from the excess profits tax.

Pages 18 and 23

Income from gold mining.—Under section 304 (c) of the 1918 law, that proportion of the net income of a corporation which is derived from the mining of gold is exempt from the excess profits tax. There was no similar exemption under the 1917 law. The 1921 law makes the income from gold mining exempt from the excess profits tax as imposed by the 1917, 1918, or 1921 laws.

LAW. Section 304. . . . . **(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title or any tax imposed by Title II of the Revenue Act of 1917, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.**

The Senate amendment to this section applied only to excess profits taxes assessed under the 1917 law and which *remained unpaid*. This discrimination between taxpayers who had paid their taxes for 1917 and those who for some reason had been able to suspend the date of payment until after the effective date of the 1921 law, was removed in conference, so that all taxpayers engaged in the mining of gold will either

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[2] Sections 217 and 233.
[3] Sections 262, see page 1324.

have the 1917 tax refunded if already paid or will not be assessed if the tax has not yet been paid.

The method of computing the tax shown on page 24 of *Excess Profits Tax Procedure,* 1921, can be applied in principle to 1917 taxes.

Page 19

The rate of 10 per cent, being the rate of income tax under the 1918 law, must be amended to read 12½ per cent, effective January 1, 1922.

Exempt corporations.—Certain changes have been made in section 231 of the law, which defines the corporations that are exempt from tax. These changes are fully dealt with in Chapter II.

Page 21

Personal service corporations.—The status of personal service corporations for 1921 is unchanged. From January 1, 1922, this class of corporations will be taxed as ordinary corporations.

The constitutionality of the method of taxing personal service corporations under the 1918 law is still in doubt. That the doubt is a strong one is evidenced by the extraordinary provision of section 1332 of the 1921 law, which provides for the taxation of personal service corporations as ordinary corporations—retroactive to January 1, 1918—if the method of taxation provided under the 1918 law is finally adjudged invalid. Full consideration is given to this question in Chapter XXIV.

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[Former Procedure]

Income from isolated transactions.—An officer of a corporation secured an option on its control several years prior to 1917, exercised the option in 1917, and earned a commission on the transaction. The Treasury held that the income

"was made possible through his business connections" and assessed the excess profits tax imposed by section 209 of the 1917 law.[1]

The foregoing ruling is hardly consistent with a recent decision of the United States District Court for the Eastern District of Pennsylvania.[2] The court held that the commissions received by a lawyer as executor of the estate of a friend need not be included in income subject to the excess profits tax imposed by section 209.

The court said:

DECISION. With respect to the theory on which the case was tried, it seems to us that it is very fairly and clearly stated in article 8 of the regulations. A contrast is there drawn, or at least distinction made, between what a person makes it his trade, profession, business, or emphatically vocation to do, what he holds himself out as prepared to do, and some particular thing of the same kind, which he does, but which is an incidental, accidental, isolated, particular thing, which he happened to do. We confess, however, our inability to grasp the thought of a distinction between such isolated things, growing out of the importance of the thing done or the demands which it makes upon the time of the person doing it. It seems to us that this works confusion in the thought of the real distinction as expressed in the regulations.

The whole thought is conveyed in an expression which is not uncommon when a person is asked to do something which, as another expression goes, is "out of his line." The expression first referred to is, "I don't make a business of doing this, but I will do it for you." The doing of it may result in such person devoting practically his whole time to it, without involving the thought of making it his business. There is much the same distinction made between amateurs and professionals in athletics, although the test usually applied there is the commercial test. Nevertheless the distinction referred to exists. The amateur does not make, as the professional *ex vi termini* does, the sport his trade, occupation, business, or profession, even although he, as he not infrequently does, devotes more time in developing and perfecting skill in it than the avowed professional does. The difference is suggestive of a difference in motive, but there is the other thought also.

This case, however, has taken a turn which compels us to take an

[1] C.B. 4, page 350, A.R.R. 350.

[2] *Cadwalader v. Lederer*, 273 Fed. 879; affirmed, August 18, 1921, 274 Fed. 753.

altogether practical view of the disposition to be made of it. The burden was, of course, upon the plantiff to make out his case. This he did, if the theory, upon which the case was submitted, was the true theory, by his testimony that his profession was that of a lawyer, and that he did not make a business of acting as executor, although he had so acted in one isolated case, wholly disassociated from his professional work.

It would seem that the commissions of a lawyer who acted as executor were "made possible by his business connections"; but the court found in effect that section 209 applies only to one's regular business, but not to isolated transactions which grow out of it.

CHAPTER IV

RETURNS

The 1921 law provides in general (section 336) that every corporation not specifically exempt[1] must make a return for purposes of the excess profits tax for the year 1921. After 1921, excess profits tax returns are no longer required. Special provisions are made, however, which provide that the returns of corporations which report on a fiscal year basis shall show the tax properly attributable to the respective calendar years.[2] A new class of corporations is referred to in section 262 (corporations in which the major part of the income is from a possession of the United States). These are to be treated as foreign corporations, and for purpose of the excess profits tax they are assessed under sections 327 and 328.[3] Inasmuch as foreign corporations are not assessed on the basis of invested capital, in making returns of income on form 1120 no computation of invested capital need be made.[4]

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[1] See Chapter II.
[2] Section 335.
[3] The relief sections—see page 1637.
[4] Reg. 62, Art. 870, Reg. 45, Art. 871.

Corporations whose entire income is derived from gold mining need not compute invested capital, because the exemption of such income from the excess profits tax provided for in the 1918 law is extended to 1921 by the new law.[5]

Returns of "government contract" corporations.—The 1921 law re-enacts those provisions of the 1918 law which impose a tax at the high 1918 rates on net income in excess of $10,000 derived from "government contracts" realized in 1921.

LAW. Section 301. . . . . (b) For the calendar year 1921 there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) of section 301 of the Revenue Act of 1918, as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit which would be applicable to such calendar year under the Revenue Act of 1918 if it had been continued in force, shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (a) of this section as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

For the purpose of computing the higher tax applicable and the proper apportionment thereof, form 1120S must be filed.

It should be noted particularly that while the higher 1918 rates are applied to "government contract" income, the excess profits credit and the war profits credit for the year 1921 are

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[5] [Former Procedure] The 1921 law (section 304-6) specifically extends to 1917 the exemption from excess profits tax of income from gold mining. See page 1568.

the same as would have been obtained if the 1918 law had been continued.

Returns for fiscal year 1920-1921.—Although the tax rates on corporations for the calender years 1920 and 1921 are the same, net income is determined differently under the 1918 law, which was in effect in 1920, than under the 1921 law, which governs 1921 returns.

LAW. Section 335. . . . . (a) That if a corporation (other than a personal service corporation) makes a return for a fiscal year beginning in 1920 and ending in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918, which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such taxable year by the Revenue Act of 1918 shall be credited towards the payment of the tax as above computed, and if the amount so paid exceeds the amount of such tax, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252 of this Act.

It will, therefore, be necessary to make, in effect, two returns; one in which the net income and the tax are computed under the provisions of the 1918 law, and the other in which the net income and the tax are computed under the provisions of the 1921 law.

Returns for fiscal year 1921-1922.—Since the excess profits tax provisions are not in effect after December 31, 1921,[6] it is necessary, in making return for a fiscal year beginning in 1921 and ending in 1922, to allocate to 1921 the proper proportion of the excess profits tax attributable to the period prior to January 1, 1922.

LAW. Section 335. . . . . (b) If a corporation (other than a personal service corporation) makes a return for a fiscal year begin-

[6] Section 301 (a).

ning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period.

There is, of course, the increased income tax at the 1922 rate which must be shown to be allocated to 1922 income in the return.

Consolidated returns.—Affiliated corporations are given the option of filing either consolidated returns or separate returns for any taxable year beginning on or after January 1, 1922.[7] The excess profits tax provisions of the 1918 law, however, are in effect until December 31, 1921, so that returns for 1921 or for fiscal years beginning in 1921 must be on a consolidated basis if the corporations are affiliated.

LAW. Section 240. . . . . **(e) Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.**

The question of what constitutes affiliation and the relevant provisions of the 1918 law governing procedure for 1921 are discussed in detail in Chapter XIV of *Excess Profits Tax Procedure,* 1921. Reference should also be made to the corresponding chapter of this appendix for rulings issued in 1921.

The Treasury required consolidated returns for excess profits tax for the taxable year 1917, although the 1917 law did not specifically so provide. The 1921 law (Section 1331)[8] in effect validates the Treasury regulations under the 1917 law requiring consolidated returns, and extends affiliation to partnerships for 1917. In specific cases, the Treasury had refused to accept returns of partnerships affiliated with corporations.

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[7] Law, section 240 (a). See Chapter XIV of this appendix.
[8] See page 1627.

Foreign corporations.—Foreign corporations are still excluded from the benefits (if any) of consolidated returns. A domestic corporation which owns a majority of the voting stock of a foreign corporation, although still allowed a credit for foreign taxes paid on account of such shares against the taxes assessed in the United States, has had such credit materially restricted by sections 238 (e) of the 1921 law which has been substituted for section 240 (c) of the 1918 act.[9]

CHAPTER V

COMPUTATION AND RATES OF THE TAX

The rates of the 1918 law applicable to 1919 and subsequent years, apply to 1921 for purposes of the excess profits tax. Special provision, however, is made in the case of fiscal year corporations. In the case of fiscal years beginning in 1920 and ending in 1921,[1] separate computations have to be made under each act (with different methods of determining net income), and the sum of the proper proportion of each resulting tax is taken. For a fiscal year ending in 1922, the computation is made for a full year and then prorated.[2] Net income from government contracts received in 1921 (if in excess of $10,000) is subjected to the higher rates at which this type of income was taxed under the 1918 law, viz., 30 and 65 per cent excess profits tax, and 80 per cent war profits tax.[3]

The limitation of tax (section 302) providing for lower rates of tax on corporations with small net incomes, has been re-enacted in the new law.

The profits taxes are imposed upon the net income for the taxable year as determined for federal income tax purposes.[4] In case of corporations which have a fiscal year, part of which

[9] For a full discussion of the limitation on credit for foreign taxes to domestic parent corporation having a foreign subsidiary, see page 948.
[1] Section 335 (a).
[2] Section 335 (b).
[3] Section 301 (b).
[4] Section 320.

falls in 1920, *the net income as determined under the* 1918 *law must also be ascertained,* and the computation of the tax must be made under that act in order to obtain the proper proportionate tax applicable to the 1920 income.[5]

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Income from government contracts.—It is important to note that while the higher rates (war profits tax) apply to net income exceeding $10,000 which was realized in 1921 from government contracts, the excess profits credits and war profits credits applicable to the year 1921, computed under the 1918 law, are to be used.

The limitation of tax under section 302[6] is also specifically made applicable to the taxes computed at the 1918 rates.

In some cases in which it was not feasible to allocate costs and expenses on the basis of gross income, the ratio of government and non-government sales to total sales has been used as an equitable method of arriving at the income to be taxed at the rates applicable.[7]

Page 62

Lower rates applicable in certain cases—no prorating of limitation under section 302.—The new law re-enacts the limitation provisions in order to give relief to corporations which have small net incomes. The provision also applies to "government contract" income which is subjected to the higher 1918 rates.

The Secretary of the Treasury had previously recommended that the old law be amended in order to provide for the reduction of the limitations of $3,000 and $20,000 in case of corporations which report for less than a full year. The Treasury had required such reduction, as set forth in Regulations 45, articles 732-733. However, Congress did not act on the recommendation, and the 1921 law contains no such requirement. The Treasury has now amended articles 732

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[5] Section 335.
[6] See Appendix C.
[7] See also C.B. 1, page 269; A.R.M. 1.

and 733 in order to allow the limitations to be applied without any proportionate reduction, as follows:

REGULATIONS. *Limitation when return for fractional part of year.*—When a return is rendered for a fractional part of a year, the limitation shall be computed in the same manner as if the period covered by the return were a full taxable year.

Illustration of computation of limitation of tax.—If in the illustration used in Article 720 the invested capital had been $100,000 and the net income $80,000, the tax computed under section 301 (a) of the statute would be $56,200. Section 302 provides, however, that tax under section 301 (a) shall not be more than 30 per cent of the net income in excess of $3,000 and not in excess of $20,000 plus 80 per cent of the net income in excess of $20,000. The tax at the 30 per cent rate will be $5,100 (art. 731) and the balance of the tax will be 80 per cent of $60,000 (the net income in excess of $20,000), or $48,000. The total tax will therefore be $5,100 plus $48,000, or $53,100. The tax under section 301 (a), amounting to $56,200, will accordingly be reduced to $53,100. (T. D. 3245, amending Arts. 732 and 733. Reg. 45, dated November 14, 1921.)

Articles 732 and 733 of Regulations 62 incorporate the above changes, the example, however, using 1921 rates instead of those for 1918.

In the official illustration given in article 733, before amendment,[8] in which the limitations were prorated:

The excess profits tax amounted to	$55,825
In the amended article, the tax is (for details see illustration on page 1579)	53,100
Excessive tax imposed	$2,725

The excessive tax may be accounted for as follows:

Part of year not prorated (3 months) 3/12	
3/12 of $17,000 ($20,000 — $3,000) = $4,250 at 30% =	$1,275
3/12 of $20,000 (limitation not reduced) = $5,000 at 80% =	4,000
Net reduction in tax due to not reducing limitations	$2,725

The 1918 rates are used in the official illustration. Of course, for 1921, the excess profits tax rates are 20 and 40 per cent.

In all instances in which taxpayers have paid an excessive tax due to the reduction of the limitations under section 302, a claim for refund, or a claim for credit should be filed.

[8] See *Excess Profits Tax Procedure*, 1921, pages 70-71.

ILLUSTRATION OF CORPORATION

REPORTING FOR PERIOD LESS THAN TWELVE MONTHS. (APRIL 1 TO DECEMBER 31, 1918) AND TAKING BENEFIT OF SECTION 302, WITHOUT REDUCING LIMITATIONS OF $3,000 AND $20,000, SINCE AMENDMENT TO REGULATIONS 45, ARTICLES 732 AND 733,[9] MAKES REDUCTION UNNECESSARY.

1918 Invested Capital			$100,000
1918 Net Income (9 months)			$ 80,000

Excess Profits Credit:

Specific	$ 3,000		
8% of Invested Capital	8,000		
	$11,000		

The Invested Capital and Excess Profits Credit are reduced in proportion to number of months in period to 12 months, viz., 9/12:

(a) 9/12 of Invested Capital $75,000

(b) 9/12 of Excess Profits Credit $8,250

First Bracket:

20% of (a)	$15,000		
Less: Excess Profits Credit (b)	8,250		
	$6,750	at 30% =	$ 2,025

Second Bracket:

Net income in excess of 20% of Invested capital	$65,000	at 65% =	$42,250
			$44,275 total Excess Profits Tax

War Profits Credit:

Specific	$ 3,000
10% of Invested Capital	10,000
	$13,000
Reduced to 9/12	$ 9,750

The War Profits Tax would be:

Net Income	$80,000	
Less: War Profits Credit	9,750	
	$70,250 at 80% =	$56,200

[9] The provisions illustrated are applicable in subsequent years, but with rates of 20 and 40 per cent, instead of 30 and 65 per cent.

But section 302 provides that the tax shall not exceed 30 per cent of the net income in excess of $3,000 and not in excess of $20,000 plus 80 per cent of the net income in excess of $20,000. Article 732 of Regulations 45 (as amended by T. D. 3245) does *not* now require these amounts to be reduced when computing the limitation of the tax for less than twelve months:

Net Income in excess of $3,000 but not in excess of $20,000=$17,000 at 30%=	$ 5,100
80% of net income ($80,000) in excess of $20,000	48,000
Total	$53,100

Therefore the Excess and War Profits Tax to be paid is $53,100

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Computation of tax for fiscal years ending in 1921 and 1922.—Two computations should be made, both for income and for excess profits tax purposes—one under the 1918 law, with its definition of net income, the other under the 1921 law, which differs in a number of particulars (deductibility of additions to reserves for bad debts, interest on loans to carry Liberty bonds, etc.). The sum of the pro rata parts of the total tax for each full year is the total tax for the fiscal period.

If the income of a taxpayer for a fiscal year ending in 1921 is the same whether computed under the 1918 law or under the 1921 law, the computation of the tax need only be made for one year, since the rates of the excess profits tax (except in the case of government contract income)[10] and the income tax are the same for 1920 (under the 1918 law) as for 1921.

LAW. Section 335. **(a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1920 and ending in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918,**

[10] See page 1572.

which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such taxable year by the Revenue Act of 1918 shall be credited towards the payment of the tax as above computed, and if the amount so paid exceeds the amount of such tax, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252 of this Act.

(b) If a corporation (other than a personal service corporation) makes a return for a fiscal year beginning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period.

For fiscal years which ended in 1921, two computations of the excess profits tax are made, each for a full year, one under the 1918 law, and one under the 1921 law, and these are then prorated. The sum of the proportional parts is the total excess profits tax payable.

Since the computations are made under two separate laws in which some of the items which make up net income and invested capital are treated differently, care must be taken to see that these are handled in accordance with the law under which the computation is being made. It is probable that a special form of return will be provided by the Treasury for fiscal year corporations, which will show the items that require different treatment under the two laws.

In the case of fiscal years which end in 1922, the excess profits tax is first computed for the entire period and then prorated. For example, assume the case of a corporation with a fiscal year ending May 31, 1922, and that the excess profits tax computed for a full twelve months' period was $36,000. The excess profits tax payable would be 7/12 thereof, or $21,000. For the method of computing the income tax in the case of fiscal years ending in 1922, see page 165.

The computation of the tax in the case of personal ser-

vice corporations which have fiscal years ending in 1921 and 1922, is dealt with in Chapter XXIV.

[Former Procedure]

The confusion that arises in the minds of taxpayers, particularly in dealing with those provisions of the law which provide for computations, is illustrated in two recent decisions involving the interpretation of section 201 of the 1917 law. In the first case[11] the court said, in part:

DECISION. According to section 201 of the Revenue Act of 1917, supra, a tax is imposed at the rate of 20 per cent upon "the amount of the net income in excess of the deduction . . . . and not in excess of fifteen per centum of the invested capital for the taxable year," etc. While the entire section is not free from ambiguity, the court is of the opinion that, having in mind the necessity of adopting a construction in accordance with the intent of Congress when the act was adopted, that urged by the government must prevail. If it had been the purpose of Congress to have the tax computed as plaintiff contends, the first paragraph of section 201 would have provided for the levy of a tax "equal to the following percentages of the net income less the deduction determined as hereinafter provided," making no mention of any deduction in the following paragraph.

If the section as it now reads is carefully analyzed, it is apparent that the amount of the net income which is to be taxed at the rate of 20 per cent is not more than 15 per cent of the invested capital for the taxable year. But not so much of the net income as is represented by such 15 per cent is to be so taxed because there must first be allowed the deduction.

The court uses a method that will prove helpful in interpreting any of the sections involving computations, viz., to restate the law so as to give effect to an alternative computation.

The same point, viz., that the exemption (in effect, excess profits credit) was not to be first deducted from the entire net income, but was to be applied to the net income in the first bracket, was also decided in another case. The effect of the

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[11] *Greenport Basin & Construction Co. v. U. S.*, 269 Fed. 58 (U. S. District Court for the Eastern District of New York, November 18, 1920).

difference in the two methods is clearly stated by the court[12] as follows:

> Decision. A comparison of the two methods shows that, by making the deduction from the first item of 15 per cent of invested capital, the amount taxed at the 20 per cent rate is diminished by the amount of the deduction, and the amount taxed at the 60 per cent rate is increased by the amount of the deduction. . . .
>
> A large part of the difficulty in construing the 20 per cent paragraph arises from the fact that the amounts involved are expressed in descriptive terms and not in figures. If the act taxed the amount of the net income in excess of $50,000, and not in excess of $100,000 we would have no difficulty in understanding that the amount to be taxed was the difference between $100,000 and $50,000.

The last sentence quoted above indicates admirably how, by substituting actual figures, a clearer conception of the meaning of the law may be obtained.

CHAPTER VI

CREDITS AND SPECIFIC EXEMPTIONS

Page 109

Domestic corporations which derive more than 80 per cent of their gross income from sources within possessions of the United States, do not receive the $3,000 exemption.[1] This is the only change made by the new law in the excess profits credit and the specific exemption of $3,000, except that it eliminates the provisions dealing with the war profits credit and specific exemption. This has resulted in a few changes in the numbering of paragraphs and subdivisions. For instance, section 301 (d) of the 1918 law now becomes section 301 (c).

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[12] *Ehret Magnesia Mfg. Co. v. Lederer*, 273 Fed. 689. (U. S. District Court for the Eastern District of Penna., No. 7044, May 23, 1921, issued as T.D. 3200, dated July 19, 1921.

[1] Section 312.

[Former Procedure] Page 120

Computation of average deduction.—The Treasury has ruled that in computing the "average deduction" under section 205 of the 1917 law, the averaging is to be done after the limitations provided in section 203 have been applied.[2]

CHAPTER VII

INVESTED CAPITAL—BORROWED MONEY

Page 123

The excess profits tax is a tax on net income, but the tax is measured by a computation of invested capital. Congress adopted a formula for the computation which, considering war conditions, corporate records, and the utter impossibility of using an actual value basis, is as nearly equitable as could be devised. From the time of the passage of the 1917 law it was certain that the constitutionality of the formula and of other sections of the law would be tested in the courts. Fortunately, the first case decided by the United States Supreme Court was one which squarely raised the most important controversial points which have been raised.

Constitutionality of excess profits tax.—In handing down its decision in the case of *La Belle Iron Works v. United States,*[1] the Supreme Court dealt with the contention raised by the appellant, that the excess profits tax was unconstitutional. The digest of the decision, published as T. D. 3181,[2] states succinctly the salient points of the decision, as it relates to constitionality, as follows:

DECISION. It was not unreasonable for Congress, in adjusting the excess profits tax, to accord preferential treatment to capital repre-

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[2] I-2-24; A. R. R. 716.
[1] 41 Sup. Ct. 528.
[2] C. B. 4, page 144.

senting actual investments, as compared with capital representing higher valuations based upon estimates, however reliable, of what probably could be realized were the property sold instead of retained. . . . .

Cases decided under the equal protection clause of the fourteenth amendment to the Constitution are not authority in determining whether a Revenue Act operates to produce baseless and arbitrary discriminations, to the extent of rendering the tax invalid under the due process clauses of the fifth amendment, as the fifth amendment has no equal protection clause, and the only rule of uniformity prescribed with respect to duties, imports, and excises laid by Congress is the territorial uniformity required by section 8 of article 1; nor are cases based upon the due process clause of the fourteenth amendment applicable. . . . .

The Act, in basing "invested capital" upon actual costs to the exclusion of higher estimated values, is not violative of the due process clause of the fifth amendment to the Constitution in that it is so wholly arbitrary as to amount to confiscation; the Act treats all corporations and partnerships alike so far as they are similarly circumstanced, and if in its application the tax in particular instances may seem to bear upon one corporation more than upon another, this is due to differences in their circumstances, not to any uncertainty or want of generality in the tests applied.

Page 127

Computation of invested capital—cash or accrual basis.—

RULING. A corporation which reports its income on a cash receipts and disbursements basis may not take accrued items into consideration in computing its invested capital. (B. 34-21-1787; O. D. 1007.)

The effect of this ruling is, that corporations keeping their accounts by the single-entry system of bookkeeping are compelled to compute their invested capital on a cash basis, omitting both accounts payable and accounts receivable, even though in a statement made up in such a form the net worth does not truly represent the amount of capital invested in the business.

Page 129

When demand notes payable to stockholders do not constitute liability.—

RULING. Recommended, that treasury demand notes drawn by order of the president of a corporation payable to its stockholders,

but not in proportion to shareholdings, do not constitute a liability of the corporation even though such notes are charged against surplus on the books of the company. (C. B. 4, page 362; A. R. R. 473.)

This case is somewhat unusual and does not enumerate a principle to be generally applied. In arriving at this decision, the Committee on Appeals and Reviews pointed out that a corporation cannot, without consideration, issue notes to its stockholders for the amount of its surplus, except by declaring a dividend pro rata according to stockholdings; and without such formal declaration the notes do not constitute a liability, no matter what entries have been made in the books of account. Furthermore, in the instant case, the notes were not delivered to the stockholders, but were held by the treasurer of the company. Hence, the amount of the notes payable should be included in invested capital.

Page 133

Dividends left in business.—

RULING. A Massachusetts corporation formally declared a dividend duly recorded in the minutes book, the resolution stating that the date of payment would be determined at a later date. Later a second dividend by informal action was credited to the stockholders, although its declaration was not recorded in the minutes book. Both dividends were credited to the respective accounts of the stockholders with the understanding among them that they were not to be drawn against and were not to bear interest. They have been treated as liabilities of the corporation from 1916 and no interest has been paid or accrued thereon.

Held, under Massachusetts court decisions, that the amount of surplus credited to the stockholders without formal action was equivalent to a dividend. Accordingly, the corporation's surplus must be reduced from the date the first dividend was formally declared and in the case of the second dividend, from the date the agreement was made informally to credit the stockholders' accounts. (B. 34-21-1786; O. D. 1006.)

This decision should be compared with A. R. M. 71 (C. B. 3, page 348). The controlling feature would seem to be the application of the Massachusetts corporation law. If the credit balances were treated as liabilities in statements for

credit purposes, such as those furnished to mercantile agencies, the ruling is sound.

Page 137

[Former Procedure]

Amended returns for 1917—community property of husband and wife.—

RULING. In filing amended returns under T. D. 3071 (C. B. 3, p. 221), husband and wife may file separate excess profits tax returns for 1917, in which the community income may be divided between them. The invested capital of either the husband or the wife should be computed by adding that portion of the invested capital which is his or her separate property to one-half of that portion of the invested capital which is community property. The full amount of the specific exemption authorized by the statute may be claimed by each. (C. B. 4, page 254; O. D. 881.)

Page 140

Advances to partners to purchase stock.—Where stock in controlled companies was purchased by a partnership, the cost being prorated among the partners and charged to their personal accounts, the stock being from time to time used as collateral for loans obtained by the partnership, it has been held that the amounts charged to the partner's personal accounts represent advances by the partnership to the partners, and do not reduce invested capital. Partners received interest on the credit balances in their capital accounts and were charged interest on the debit balances referred to above.[4] The distinction is made between specific advances to purchase stock and debit balances representing withdrawals of capital.

Page 141

Invested capital of partnerships.—The Treasury has held that debit balances of partners representing moneys advanced by the partnership may be included in invested capital.[5] The ruling is somewhat inconsistent with former rulings. Emphasis is placed upon the fact that interest was charged on

[4] B. 39-21-1848; A. R. R. 619.
[5] B. 39-21-1848; A. R. R. 619.

the balances and that the securities individually purchased and owned by the partners were available as collateral.

There is not the slightest difference between large debit and credit balances and one account with a net balance. Thus a partner has a credit balance of $1,000,000; he withdraws $500,000 and invests it in securities. According to the rulings the partnership would have $1,000,000 of invested capital if it kept two ledger accounts, and $500,000 if it kept one account! The treatment of interest is similar; crediting interest on $1,000,000 and debiting interest on $500,000 is precisely the same as one calculation of interest on a net credit balance. The invested capital of partnerships in 1917 depends on facts—not on bookkeeping methods.

CHAPTER VIII

INVESTED CAPITAL—ADJUSTMENT OF ASSET VALUES

The decision of the Supreme Court in *La Belle Iron Works v. United States*,[1] has clarified many matters relating to invested capital. It is held that unrealized appreciation has no place in invested capital,[2] cost alone being admissible; however, the court clearly brought out the fact that the cost (less adjustments for depreciation, depletion, etc.) of all assets in existence on January 1, 1917, should be included in invested capital at that date.

The application of this decision to specific phases of the subject is brought out in the following pages.

Page 146 (footnote)

Revaluation at January 1, 1914.—In the *La Belle Iron Works* case,[3] the court disallowed appreciation in value as an

[1] 41 Sup. Ct. 528; issued as T. D. 3181.
[2] Except when January 1, 1914, revaluations are provided for.
[3] 41 Sup Ct. 528.

element in invested capital, but commented at some length upon the exception to the rule found in the 1917 law. In view of previous attempts by the Treasury to restrict the scope of the section, it is of interest to note that the court's references indicate that, when called upon to interpret section 207 (a) of the 1917 law, the intention of Congress to *permit* the inclusion of appreciation will be upheld. The cases in which advantage of the section can be taken are extremely few, but when a case arises it should receive the full benefit of the privilege.

Appreciation in values must not be included.—The La Belle Iron Works, prior to 1904, acquired a tract of ore lands for $190,000. Through development and exploration large bodies of ore were discovered, and by 1912 the ore body was valued at $10,105,400. In 1912 the company revalued its property on its books and declared a stock dividend of $9,915,400. In making its tax return for 1917 the company included the 1912 revaluation in its invested capital. The Treasury disallowed the appreciation; the company paid an additional tax and then brought suit for refund. The lower court decided against the company, and the Supreme Court affirmed the decision of the lower court on May 16, 1921.[4]

The decision is voluminous, but does not require extended comment. The court refers to the consideration which Congress gave to the "value" basis for invested capital and the difficulties and possible evasion which would follow if interested parties were permitted to use their own estimates of values. The court comments upon the final adoption of the term "invested capital," and places peculiar emphasis upon the word "invested," which it holds to preclude appreciation or increment in value. The decision greatly strengthens claims for actual values paid in. This point is commented upon elsewhere.[5]

The author has consistently advised taxpayers that appre-

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[4] 41 Sup. Ct. 528.
[5] See page 1609.

ciated values cannot, under any circumstances, be included in invested capital until realized,[6] nor can appraisals, however scientifically made, increase invested capital if the element of unrealized appreciation is in any way included.

The difference between restoring capital items improperly or inadvertently charged off prior to 1917, and including appreciated values, will always be a troublesome point. General rules are not applicable. Each case must be judged according to the facts which a careful analysis of the accounts reveal.

Where, however, it can be shown with reasonable assurance that an appraisal value does not contain a material amount of appreciation, but that on the contrary it is on a basis substantially of cost less depreciation actually accrued, the author sees no objection (nor is there any inhibition against it in the excess profits tax laws) to using such an appraisal as the basis for restoring in effect capital expenditures which were absorbed in operating expenses in earlier years.

Where appraisals were made prior to the war period, or can otherwise be shown to exclude any appreciation, it would appear that an appraisal may in some cases be even a better and more effective means of restoring to the accounts capital expenditures previously absorbed in operating expenses, than the identifying of specific expenditures and the setting up of theoretical depreciation thereon. The appraisal has the advantage of making certain that the plant facilities or additions represented by the capital expenditures previously written off are still in use; also the depreciation actually sustained or accrued is based on an actual survey of the property.

The present attitude of the Treasury regarding appraisals is shown in the following:

RULING. The Committee has reconsidered its Recommendation 490 (not published) in the matter of the appeal of the M corporation from the action of the Income Tax Unit in assessing excess profits taxes for the year 1917 under the provisions of section 210 of the Revenue Act of 1917 and for subsequent years under the provisions of sections 327 and 328 of the Revenue Act of 1918.

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[6] Always excepting the January 1, 1914, provision.

In a memorandum from the Unit transmitting this case to the Committee the following statement is made:

The corporation was organized in 1914 and took over the assets and assumed all the liabilities of two going concerns, the O corporation and the P partnership, the entire capital stock of the new corpraotion, $4x$ dollars, issued to the stockholders of the old corporation and the members of the partnership. The evidence submitted in the form of various appraisals shows that the assets acquired had a valuation far in excess of the capital stock. The corporation, however, could not submit any data showing the cost of the assets, as the records had been destroyed by water. In January, 1921, appraisals of the different classes of assets were made as of 1914 by different individuals assisted by others who were employed by the corporation in 1914. In the conference the manager of the corporation first stated the method used in determining whether the assets listed were acquired in the consolidation in 1914 was by taking an appraisal made in 1917 and eliminating therefrom all items shown by the books to have been purchased and charged to the asset accounts from 1914 to the date the appraisal was made. Later he stated that the appraisal was made by the former employees going through the department and listing the assets which from their own knowledge were acquired in the consolidation and afterwards comparing these items with the appraisal made in 1917.

In the consideration of this cast it is necessary to refer to the provisions of the Revenue Act of 1917 which deals with tangible property paid in for stock. The pertinent part of section 207 (a) reads as follows:

. . . . (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January 1, 1914, the actual cash value of such property as of January 1, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year. . . .

Article 63, Regulations 41, interprets the foregoing provisions of the statute and reads as follows:

Where it can be shown by evidence satisfactory to the Commissioner of Internal Revenue that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid-in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time.

Evidence tending to support a claim for paid-in surplus under these circumstances must be as of the date of conveyance, and may consist, among other things, of (1) an appraisal of the property by disinterested authorities, (2) the assessed value in the case of real estate, and (3) the market price in excess of the par value of the stock or shares.

The pertinent part of the Revenue Act of 1918 reads as follows:

. . . . (2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in

no case to exceed the par value of the original stock or shares specifically issued therefor; unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus. . . .

Article 836, Regulations 45, interprets the foregoing quoted provision of the statute and reads in part as follows:

Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment, and may consist among other things of (*a*) an appraisal of the property by disinterested authorities made on or about the date of the transaction; (*b*) certification of the assessed value in the case of real estate; and (*c*) proof of a market price in excess of the par value of the stock or shares. The additional value allowed in any case is confined to the value definitely known or accurately ascertainable at the time of the payment. . . .

The records in the case show that for several years prior to 1914 the P partnership had conducted a repair business. In 190– a corporation known as the O corporation was incorporated, its entire capital stock being owned by the P partnership. In 1914 this corporation and the P partnership, consisting of A, B, and C, were consolidated and incorporated under the name of the M corporation, with a capital stock issue of 4*x* dollars. This capitalization was nominal and was not based on any valuation of either plant, as it was not deemed necessary to set an actual value on the asset because of the fact that all the corporate stock was held by the three members of the partnership. During the lifetime of A the partnership's accounting system was very lax and, as shown by a number of affidavits filed in behalf of the M corporation, all the books, balance sheets, and other accounting records of the P partnership and the O corporation were rendered useless during a storm in 1918, so that at the present time no records exist from which might be obtained a complete statement as to the cost of the assets taken over by the M corporation in the consolidation of 1914. Under these circumstances the Unit holds that the statutory invested capital of the corporation can not be satisfactorily determined, and proposes to make assessment of excess profits tax under the provisions of section 210 of the Revenue Act of 1917 and section 328 of the Revenue Act of 1918. The corporation has had various appraisals and estimates made in an effort to show the value of the assets in order to establish a claim for paid-in surplus, which appraisals may be classed as follows:

(1) Two appraisals were made by engineers versed in the particular line of business in 1917.

Each of the gentlemen who fixed upon the values shown above was undoubtedly well qualified to make appraisals covering the assets of the character owned by the M corporation, but it is to be noted that while there is a net difference of but 2*x* dollars between the totals of the two sets of figures no one unit was given the same value except

in the case of automobiles, etc., the difference in the values given the other items ranging from 1/10x dollars in the case of office furniture to 2½x dollars in the case of other property, which in a measure indicates the difficulties experienced in fixing upon definite values.

(2) Three affidavits as to the value of the property taken over by the M corporation were submitted by persons familiar with values of such property.

Each of these gentlemen stated in his affidavit that of his own knowledge and belief the plant and equipment of the P partnership in 1914 was worth 60x dollars, while the fair value in 1914 of the plant and equipment of the O corporation as estimated by one of them was 241x dollars and by the other two about 240x dollars, although no value is placed upon any individual assets.

(3) Three affidavits similar to the next above made give a value of 291x dollars.

(4) A composite appraisal made in 1921—assets being divided into classes and itemized and each class appraised by men particularly qualified for the work, showing a total value as of 1914 of 304x dollars.

This last appraisal was taken subsequent to a conference held in 1920 between representatives of the taxpayer and members of the Income Tax Unit, during which the former were advised that in order to establish a claim for paid-in surplus evidence must be furnished showing the assets taken over upon consolidation, the cash value of the assets as of that date, the cost of subsequent additions by years, the proportion of such cost, if any, which had been included in the deductions claimed on taxpayer's returns, and the assessed value of the properties. To each individual appraisal which forms a part of this composite appraisal is attached an affidavit signed by the appraiser indicating the character of the work performed and the experience had by him in the past which would serve to qualify him to place fair and just values on the particular class of assets covered by his appraisal, but the appraisals contain little or no evidence of the facts upon which they are based and as to how they acquired their information or data to make up the appraisals, or as to how the appraisals were constructed. It was stated during a conference granted representatives of the taxpayer by this Committee that no assets were included in these appraisals except such as were positively known to have been in the possession of the P partnership and the O corporation and taken over by the M corporation at the time of consolidation except an item of "Hand tools," etc., valued at 4x dollars, with reference, to which the representatives of the taxpayer volunteered the information that such item was a mere estimate. No other proof is submitted to show how it was known that nothing was included except that which was in the possession of the company in 1914.

Accompanying this appraisal are statements taken from the books showing the amounts expended in the purchase of additional assets during the years 1914–1919, the amount of depreciation charged off during each of those years, and a summary showing the adjusted values of all lands, buildings, machinery, and equipment for the years 1914-1919 based on the appraisal made as of January 1, 1914.

As shown above, the appraisals forming the first set were taken in 1917 and show values as of that year. The affidavits forming the second and third sets contain nothing except general statements to the effect that in the opinion of the affiants the assets taken over upon consolidation were worth certain amounts in 1914. Neither of these appraisals or estimates, therefore, can be said to be of such a satisfactory and convincing character as to justify the acceptance of the values therein stated for invested capital purposes in the computation of excess profits tax liability without further investigation by the Unit to ascertain whether such values were computed upon the basis outlined herein.

The representatives of the taxpayer have stated to the Committee that their whole objection to assessment under the provisions of sections 210 and 328 of the Revenue Acts of 1917 and 1918, respectively, is on the ground that such a method of assessment affords no stable basis from year to year for a determination of the corporation's tax liability, for which reason they desire that the corporation be classed as one having a determinable statutory invested capital rather than as one entitled to relief under the provisions of the said sections even though its tax liability be greater under the first method than under the latter.

The values as stated in the four sets of appraisals mentioned above were apparently fixed by men who were well qualified for the work, but a different value is stated in each appraisal, which indicates the difficulties experienced in carrying out such a task and the practical difficulty in establishing cost. The first appraisal being taken at 1917 values, and the affidavits comprising the second and third appraisals, so called, being nothing more than general statements, can not be accepted.

The fourth appraisal, while stated in detail, shows in some cases approximations and not actual ascertainment of values. That part of this appraisal which covers fire protection system, plumbing and piping, indicates that the great majority of the items so covered was approximated, while that part which covers certain other property indicates that the quantity of material entering into the construction of such assets has been approximated. Errors in stated figures which affect the total value shown have also been made. While many of the assets covered by this appraisal are of such character and size, such as lands, large machines, etc., as to be easily identified as having been among the assets transferred, even after a lapse of years, by

those who had worked with, around, and among them, and their value as of time of transfer more or less satisfactorily established, yet it is to be noted that this appraisal covers hundreds of very minor items which, because of their lack of size, importance, and cost, ranging in stated figures from a few cents to not more than $50, lack distinctive character, and the Committee finds it hard to believe that such assets would so firmly fix themselves in the remembrance of any man or men as to permit such persons to positively identify them in 1921 as having been the identical articles which were in the hands of the P partnership and the O corporation and transferred to the M corporation in 1914, especially when it is known that many of such items were removed from a plant and reinstated and rearranged in new buildings in another community. It is also shown by an appraisal made in 1917, by competent men, and before the loss of the book records, that the value of the assets at that time was a little less than 240x dollars and there is nothing to show why the assets were worth approximately 60x dollars more in 1914 than in 1917.

It was stated in conference that since the consolidation in 1914 accurate book records have been kept from which it is possible to accurately determine just what additions to the plant had been made in order that the appraisals as of 1914 might contain nothing acquired since consolidation, and yet, in a statement filed with the Unit, the cost of such additions made during the year 1917 was stated as 1¼x dollars, while in a later statement such cost is stated as 1 1/6x dollars, which fact throws doubt upon the accuracy of such book records as have been kept. In the said appraisal the value of all flat lands, regardless of location or character, is stated at a certain amount per square foot, but no statements have been submitted showing the values placed thereon for local tax purposes.

In the consideration of the case the Committee has pointed out certain discrepancies in the appraisals which it is sought to have the Income Tax Unit accept as a basis for the allowance of a paid-in surplus. These discrepancies raise a doubt as to the accuracy of the figures submitted in such appraisals and of the facts upon which such appraisals are based. The appraisals in question are apparently based upon the opinions of persons qualified to testify in a matter of this kind, but it does not appear that the inventory of the assets of this corporation, as enumerated in the appraisals, has been valued upon a cost basis. It is thought possible to so value the assets in this case when the appraisals have been modified in accordance with the method hereinafter outlined and to this end the Unit should make or have made an independent appraisal for the purpose of verifying or checking the amounts and values stated in the appraisals submitted by this company before accepting same as representing sound values of the assets at the time they were paid in to the corporation in 1914.

In the past it has been the policy of the Bureau to construe

strictly the requirements of article 63, Regulations 41, and article 836, Regulations 45 (1920 edition). As a result of such construction of these articles numerous retroactive or retrospective appraisals have been rejected as a basis for a claim for paid-in surplus. The Committee has made an exhaustive study of appraisals and their relation to invested capital of corporations. It has also considered appraisals in connection with establishing March 1 values for purposes of depreciation and depletion, and for purposes of establishing certain values in connection with amortization claims, and has reached the conclusion that the Unit has been too strict in interpreting the provisions of the statute and the articles of regulations interpreting same quoted above, and that retrospective appraisals, if made upon the basis hereinafter outlined and proof is furnished of the facts upon which they are based, may properly be accepted as a basis for the allowance of a paid-in surplus. The Unit, as well as the Committee, is continually fixing values for one purpose or another. This is particularly true in fixing the March 1 values for the purpose of computing gain or loss upon the sale of an asset which has been held for some time and which is of a class not regularly dealt in by the public.

In the instant case it is not only necessary to determine the actual cash value of the tangible assets at the time paid in in 1914 for the purpose of invested capital, but it is necessary to determine the fair market value of the depreciable property so paid in as at March 1, 1913, for depreciation purposes and also for the purpose of ascertaining whether or not the stockholders in the O corporation and the partners in the P partnership derived any profit from the sale of these assets to the M corporation. It is understood that the stockholders and copartners did not include any profit in the computation of their net income for the year 1914.

In making a retroactive or retrospective appraisal to show the actual cash value of tangible assets at the time paid in at some date in the past, care should be exercised in order to eliminate any appreciation written upon the books of the corporation since the date of acquisition, and also to value the assets in question at cost. In the case of the *La Belle Iron Works v. United States* (C. B. 4, page 373), decided by the Supreme Court on May 16, 1921, it was held that any appreciation in value of property over its cost is not to be included in invested capital as paid-in surplus. Treasury Decision 3220 (Bulletin 37-21-1822) was promulgated subsequent to this decision and requires the filing of amended returns in all cases where taxpayers have written appreciated or inflated values upon their books and have used same in determining the amount of their invested capital. It would, therefore, appear that no appreciation over cost can be recognized in the computation of invested capital and that appraisals made for the purpose of establishing invested capital and for the

purpose of allowance of a paid-in surplus should be based upon the actual cost of the tangible properties as they existed at the time they were paid in, giving particular attention and consideration to the original cost and depreciated reproduction cost as at the basic date and the remaining expectancy of life. In order to accomplish this result it will be necessary to inventory at cost as of the basic date (the date of acquisition) the property then on hand and in many cases to establish by historical investigation the date of original acquisition, date of renewal, and the cost of additions made subsequent to the date the property was paid in. Adjustments should be made for property scrapped or discarded and for depreciation.

The books of account, if available, should be considered the best evidence as to dates of acquisition and actual cost. The asset account showing the tangible property may be incomplete for many reasons and may include property still on the books that has been discarded as well as property in existence that has never been capitalized or entered on the books and certain arbitrary amounts charged off as depreciation which have no relation to the expired and remaining life of the property.

The tangible property actually in existence and in use should be considered as the basic evidence of the invested capital in existence and should be used as a basis for the proper correction of the accounts to correctly reflect the actual investment in the depreciable properties in existence during the taxable years.

The burden of proof is upon the taxpayer when a claim for a paid-in surplus is made, and in so far as the records of the taxpayer may be incomplete or the regulations permit values of the property at the date paid in should be established by proof. The regulations quoted above do not prescribe any specific method for ascertaining the facts, but only indicate some of the means by which appropriate proof may be furnished which would be acceptable to the Bureau. A retrospective appraisal is in substance the opinion of experts based upon the facts presented to them and as such is admissible as evidence of a paid-in surplus, but its value as proof of a paid-in surplus must depend upon the truth of the facts upon which it is based. Necessarily, if any of the facts presented to the experts are not accurate, the experts' opinion is inaccurate to the extent that such facts are inaccurate. In order, therefore, for the Bureau to accept as conclusive a retrospective appraisal, it must be satisfied under the regulations that the facts upon which the appraisal is based are true. In determining whether or not the facts are true the Bureau should accept such proof of the facts as is ordinarily accepted in business transactions of like character. In all such inquiries the Bureau is dealing with facts which themselves come within the control of human will or human caprice, and the evidence for which depends on the trustworthiness of human informants. Such evidence may range

through every degree, from the barest likelihood to that undoubted moral certainty on which every man acts without hesitation in practical affairs. The Bureau must receive and consider such appraisals, therefore, with a sound and intelligent discretion as it considers much other evidence, and be content to accept them, without being able to prove their accuracy as mathematicians judge accuracy, if they convince the mind of their correctness to that moral certainty upon which practical men of affairs act.

In view of the foregoing, it is recommended that the action of the Income Tax Unit in holding that the invested capital can not be satisfactorily established and that assessment of excess profit taxes for the year 1917 should be made under the provisions of section 210 of the Revenue Act of 1917 and for the subsequent years under the provisions of sections 327 and 328 of the Revenue Act of 1918 be reversed; that Committee on Appeals and Review Recommendation 490 sustaining the action of the Unit be revoked; that retrospective appraisals be accepted as evidence of paid-in surplus when made upon the basis herein outlined and the facts upon which the appraisals are based have been established by proof; that the retrospective appraisals and the facts upon which they are based in the instant case be verified to determine the method of their construction and the truth of the facts upon which they are based; and that in this and in all similar cases where the law directs that the value of property at a given basic date be ascertained, the Unit be instructed to receive such proof of the facts as is ordinarily accepted in important business transactions of like character and that the practice which has obtained in the Unit in refusing to receive such proof on the ground that it consisted of so-called retroactive appraisals be discontinued. (I-5-60; A. R. R. 747.)

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Salaries waived by officers of corporation constitute paid-in surplus.—

RULING. The return of a corporation for the year 1920 showed a deficit of $2x$ dollars. One of the liabilities of the corporation was a valid obligation to pay its three officers salaries amounting to $3x$ dollars. The officers waived their right to these salaries and in January, 1921, the corporation credited its surplus account in the amount of $3x$ dollars.

Held, that the amount of the salaries, the right to which was waived, is paid-in surplus and not income of the corporation for the year 1920. (B. Digest 37-21-1821; O. D. 1034.)

Cancellation by stockholders of claims owing to them.—

RULING. The original paid-in capital of a corporation is unchanged by an operating deficit, and the cancellation by stockholders

of claims owing to such stockholders resulted in effect in an additional contribution to the corporation's capital account which assumed for the purposes of invested capital the nature of paid-in surplus. This is true regardless of any transfers of stock as between the stockholders which may or may not have been a consideration moving to the cancellation of the claims. (B. 47-21-1936; A. R. R. 678.)

Property acquired by merger must be valued at cost.—

RULING. The M Company was organized subsequent to 1919. Soon thereafter it acquired all the capital stock of the N Company by issuing to the stockholders of the N Company its own stock in an amount equal to the par value of their shares of stock. The M Company thereupon by merger absorbed the N Company and became the owner of all the property of the N Company, which consisted of real estate, buildings, machinery and equipment, stock on hand, and work in process. This property had been purchased by the N Company in the same year at a bargain, as shown by an appraisal made of the property about the time it was taken over by the M Company.

Held, that the company could not include in its invested capital as paid-in surplus the excess of the value of the property over the purchase price paid therefor. Any excess resulted from a successful bargain and is not paid-in surplus. Paid-in surplus as used in section 326 of the Revenue Act of 1918 does not mean the excess value of property purchased in a bona fide sale over the purchase price thereof. To constitute paid-in surplus of a corporation there must, in effect, be a gift to the corporation. (C. B. 4, page 384; O. D. 813.)

The above ruling is sound unless the stockholders of M and N companies were to a substantial degree the same. In such case the element of gift *would* be present.

Paid-in surplus.—The decision of the United States Supreme Court in the *La Belle Iron Works* case[7] greatly strengthens the position of taxpayers who legitimately claim that at the date of acquisition assets were undervalued. The claim of the La Belle Iron Works Company was rejected because it was conceded that the appreciation in value arose after the acquisition of the property. The company was allowed the full value of the capital which it "invested"; subsequent increments in value were disallowed. When values existed at

[7] 41 Sup. Ct. 528.

the time property was paid in, the Supreme Court held that Congress intended that full effect must be given to such values, even though, at the time, the values in excess of the par value of the stock were not set up on the books.

In specific language the Supreme Court holds that the definition of invested capital in the laws contemplates the inclusion of "what actually was embarked at the outset or added thereafter, disregarding any appreciation in values."

The court, in defining the word "invested," discussed the two major elements which must be present and added, "in either case involving a conversion of wealth from one form into another suitable for employment in the making of the hoped-for gains."

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When contracts constitute paid-in surplus.—

RULING. Paid-in surplus must consist of tangible property transferred to the corporation, either as a gift or at a value which is less than its actual cash value; and in practically all cases where allowable, involves no substantial change of beneficial interest.

Contracts which are regarded as tangible assets can only constitute paid-in surplus when such contracts are made between outside parties, and the rights of either of such parties are transferred to the corporation without adequate compensation. Contracts to which the corporation itself is a party may not be so included. (C. B. 3, page 347; A. R. R. 233.)

Amended returns resulting from increase in book values of assets.—

RULING. Where a corporation claims as an addition to its invested capital for 1917 and subsequent years the excess of the value of its patterns over the value at which they have been carried on its books, and such claim comes within the provisions of articles 840 (2) and 841 (1) of Regulations 45, amended returns may be filed for each year for which an erroneous return has been made both before and after March 1, 1913. Any overpayment of taxes for the years 1917 to 1920 shown on the basis of the amended returns may be made the subject of a claim for refund. (C. B. 4, page 391; O. D. 901.)

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Reduction of surplus because of alleged failure to charge off sufficient depreciation.—In the 1921 edition of *Excess Profits Tax Procedure,* the author questioned the growing practice of revenue agents of going back (sometimes fifty years) and restating plant accounts "with a result on January 1, 1917, which is absurd." The further statement was made that the burden of proof was not on taxpayers to establish the propriety of the January 1, 1917, book values of plant assets. The author's contentions have been fully recognized in the following rulings.

Ruling. The Committee is in receipt of a request for advice relative to the practice of field agents in reducing earned surplus by deductions for depreciation where none have been claimed in the past, or where a lower rate has been claimed than is ordinarily allowable with respect to the depreciable assets in question.

It is the judgment of the Committee that there is no warrant for reducing earned surplus because of alleged failure to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their actual value at that time. This is particularly true where the corporation in prior years earned positive income from which larger deductions for depreciation might have been taken, if in the opinion of the officers and directors of the corporation such larger charges had been justified. Nothing herein is to be construed as precluding the Income Tax Unit from adjusting depreciation, either by way of increase or decrease, where there is at hand affirmative evidence that as at the beginning of a taxable year the amount of depreciation written off in prior years was insufficient or excessive. The correct attitude of the Bureau and the proper conduct of its field agents, in particular, are plainly set forth in that part of Art. 839 of Reg. 45, which reads:

> "Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be."

(C. B. 4, page 390; A. R. M. 106, dated February 26, 1921.)

This very important memorandum was followed by an almost equally important statement defining "actual value" and explaining very specifically how depreciation shown on the

books is to be compared with the actual assets. The text of the memorandum is as follows:

RULING. Specific inquiry has been made as to the meaning of the words "actual value" as used in Committee on Appeals and Review memorandum No. 106. For the purposes of taxation depreciation is based upon cost. Accordingly, the words "actual value" mean "sound value", which is "original cost" (or value as of March 1, 1913, if applicable), including additions and betterments charged to capital account, less depreciation sustained.

Article 161, Regulations 45 (1920 edition) defines the proper allowance for depreciation as "that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date."

It follows from this definition that any action on the part of a particular taxpayer which extends the useful life of a depreciable asset beyond the normal or usual term, and any circumstance which serves to increase the salvage value of a depreciable asset, operates to justify a reduction in the normal rate of depreciation. The depreciation of an asset is arrested where it is maintained at a high standard of efficiency either by the exercise of unusual care in its use or by unusual maintenance expenditures.

Invested capital, as defined in the Excess Profits Tax Law, is a statutory concept and is composed of two elements: (a) original contribution, and (b) earnings of the corporation available for distribution but not distributed and not dissipated by subsequent operating losses. The exhaustion of this capital through use, wear and tear has, for the purpose of computing invested capital, the same effect as an operating loss and unless this loss is properly taken care of out of earnings in one way or another, earned surplus must be adjusted in accordance with the provisions of the regulations. There are two ways of taking care of this loss out of income. One is by charging ordinary repairs directly to expense and setting up a depreciation reserve against which are properly chargeable all renewals and replacements; the other is where renewals and replacements, as well as repairs, have been charged directly against gross income. Either way has the effect of reducing the amount added during the year to earned surplus. Consequently, the mere fact that no depreciation, or a minimum depreciation, has been charged as such, is not sufficient reason for reducing the earned surplus, where renewals and replacements sufficient to care for the decrease in value of capital assets have been charged directly to expense, or

where for any of the other reasons hereinbefore suggested less than the normal rate of depreciation is properly chargeable. When a taxpayer makes this claim there are two methods of verifying it. One is by determining the plant efficiency and the other is by determining the value of the capital assets remaining. From an administrative standpoint the latter is probably more practical even though it may be said that the former is more accurate.

Many cases have been brought to the attention of the Committee where corporations have been in existence for a long period of years, some of which corporations have been in existence several times the ordinary estimated life of the depreciable assets, and yet those assets are today in first-class condition and worth the figure at which they are carried on the books, although no depreciation has been charged as such and no additions to capital account have been made. In such cases it is obvious that depreciation has been adequately cared for by charges to expense, although it frequently happens that it is impossible at this late date to segregate and specify such charges and there is no warrant in the law or the regulations for requiring the depreciable assets in such cases to be written down below the figure at which they are carried on the books, since to do so is to reduce earned surplus twice, once through the original charge to expense (whether proper or improper), and again through an arbitrary depreciation charge required by the Bureau to be set up against earned surplus for the purpose of computing invested capital.

The controlling rule in this matter is found in that part of Article 839 of Regulations 45, which reads: "Adjustments in respect of depreciation or depletion in prior years will be made or permitted only upon the basis of affirmative evidence that as at the beginning of the taxable year the amount of depreciation or depletion written off in prior years was insufficient or excessive, as the case may be." *Mere failure in prior years to have written off on the books the maximum or ordinary rate of depreciation, is not in itself "affirmative evidence."* There is no warrant for reducing earned surplus because of alleged failure to charge off sufficient depreciation in the past, unless the depreciable assets of the corporation are valued on its books at the beginning of the taxable year at an amount in excess of their sound value at that time. (B. 30-21-1748.)

This memorandum explanatory of A. R. M. 106 was followed by an office decision, signed by Commissioner David H. Blair, reading as follows:

RULING. Reference is made to Committee on Appeals and Review Memorandum 106 (C. B. 4, p. 390) and explanatory memorandum of the Committee dated July 6, 1921 (Bul. 30-21-1748.)

The attention of the Commissioner's office has been called to the fact that article 839 of Regulations 45 as interpreted by Committee Memorandum 106 and the memorandum of July 6th has not been properly followed.

When the Regulation (art. 839 of Reg. 45) was being drafted it was the intention of the draftsmen that a corporate surplus account was not to be disturbed lightly and that no change should be made in it either by the Government or by the taxpayer except upon adequate evidence that the surplus account was incorrect. It was the view of the draftsmen that unless the taxpayer could show a state of error the Government should deny a claim for an increase in the surplus shown by the taxpayer's books; conversely, before a deduction could be made from the taxpayer's surplus account, the Government must show that such an adjustment is necessary to correct the account. The view was also held that such proof must be in the form of affirmative evidence; that it could not rest upon mere assertion or the working out of the theoretical formula.

It is my opinion that no doubt ever should have existed as to the correct interpretation of article 839. A taxpayer's corporate surplus should not be reduced by the arbitrary adjustment of depreciation and depletion for past years. Surplus accounts should, however, always be carefully scrutinized and checked up for the purpose of preventing the inclusion therein of appreciated values of property In case of doubt in such case the burden should be cast upon the taxpayer to prove that no appreciated values were included in the surplus. A presumption should always exist that a taxpayer's books of account reflect actual facts. The burden of proof is upon any one who attempts to impugn the correctness of the books of account—upon the Government if it seeks to reduce its surplus account by charging off depreciation and depletion which have not been claimed by the taxpayer and upon the taxpayer where he claims that too much depreciation and depletion have been charged off in prior years. (B. 46-21-1926; O. D. 1104.)

The practical value to taxpayers of A. R. M. 106 was much reduced by the decision of the Supreme Court in the *La Belle Iron Works* case.[8] In that decision the right of taxpayers to include in invested capital at January 1, 1917, the cost (less actual depreciation to date) of all assets on hand at that date was definitely established. Whether such is permitted by A. R. M. 106 is more or less irrelevant.

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[8] 41 Sup. Ct. 528.

An insistence on its rights as to the inclusion in invested capital as at January 1, 1917, of the cost of all its assets, does not preclude a taxpayer from claiming depreciation on the March 1, 1913, value of its assets, quite independent of the fact that the latter value includes appreciation. *The bases for invested capital and for depreciation are entirely distinct.*

When appreciation has been included in invested capital, amended returns are required.—The United States Supreme Court in the *La Belle Iron Works* case[9] has decided once for all that the formula for the computation of invested capital, set forth in the 1917 and 1918 laws, is legal and must therefore be enforced. From the time of the enactment of the 1917 law the author has contended that the cost basis is arbitrary and inequitable in many cases, but that it is legal and more workable than if the proposed basis of value (irrespective of cost) had been adopted. There was no justification under the laws for including unrealized appreciation of tangible or intangible assets. So-called "experts" who widely advertised their ability to compel the Treasury to accept such bases have deceived their victims.

In cases like that of *La Belle Iron Works*, the laws afforded reasonable relief. It is obvious that an invested capital of less than $190,000 for an ore body worth $10,000,000 would have brought the company within the relief sections of the 1917 and 1918 laws.

The Treasury, following the decision referred to above, issued the following decision on August 26, 1921. This requires the submission of amended returns in all cases where appreciated values were used in computing invested capital.

RULING. An examination of income and excess profits tax returns for 1917 and subsequent years has disclosed that many taxpayers have used appreciated and inflated values in determining

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[9] *La Belle Iron Works v. U. S.*, 41 Sup. Ct. 528.

invested capital shown in such returns contrary to Section 207 of the Revenue Act of 1917 and Section 326 of the Revenue Act of 1918.

This office has held consistently that the use of appreciated or inflated values in determining invested capital is not permissible and this ruling has been sustained by the United States Supreme Court in the case of the La Belle Iron Works v. The United States (41 Sup. Ct. 528; T. D. 3051.)

All taxpayers who, in the preparation of their income and excess profits tax returns for 1917 and subsequent years, have used appreciated or inflated values in determining the amount of their invested capital are required to file with the Collector of Internal Revenue within 90 days from date of this decision amended returns for each of such years, in which the invested capital shall be computed strictly in accordance with the law and regulations and without the use of appreciated or inflated values. It is not required that such amended returns shall include the figures shown in the original returns which are unaffected by this decision. Only such figures as are necessary to show the correct values used in the computation of invested capital and such totals as are necessary to a redetermination of the tax need be shown. Payment of the additional tax shown to be due on such amended returns must also be made at the time the returns are filed.

Failure to file amended returns within the time specified will subject taxpayers to the penalties provided for in Section 3176, United States Revised Statutes, as amended. (B. 37-21-1822; T. D. 3220.)

The intention of the government in requiring amended returns within ninety days from the date of the Treasury decision (i.e., on or before November 24, 1921) was to have the tax due as the result of appreciated values paid immediately, rather than to allow it to wait until the returns were finally reached in the course of audit. An extension of time from November 24, 1921, until January 15, 1922, was afterwards granted in which to file the amended returns and make payment of the tax due.[10] The fact that no further tax may be shown to be due on the amended returns in such cases is not sufficient to waive the filing of such returns.[11]

AMENDED RETURNS NOT REQUIRED IN CERTAIN CASES.—The Treasury has excepted certain cases from the requirements of T. D. 3220.

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[10] T. D. 3243.
[11] B. 49-21-1968; O. D. 1131.

RULINGS. Where for the year 1918 returns were filed and the war and excess profits tax paid was equal to 50 per cent of the net income, relief having been requested under sections 327 and 328 of the Revenue Act of 1918, or where for the year 1917 returns were filed under article 64 of Regulations 41, and full disclosure was made on the return of the inclusion therein of restorations to invested capital, amended returns will not be required under T. D. 3220 (Bul. 37-21, p. 18) and T. D. 3243 (Bul. 48-21, p. 18). However, in cases where returns were filed under article 64 of Regulations 41 and no disclosure was made of the inclusion therein of restorations to invested capital, the requirements of T. D. 3220 and T. D. 3243 must be complied with. (I-2-25, I. T. 1163.)

In determining invested capital for 1917 and subsequent years the taxpayer, an insurance company, used security valuations demanded and furnished by the insurance department of the State and, as required, filed a copy of its State report with this office.

Owing to its inability to furnish cost values of securities, advice was requested as to what action should be taken in order to comply with the provisions of Treasury Decision 3220 (Bulletin 37-21, p. 18).

Held, that as the invested capital of insurance companies is adjusted by this office on the basis of cost from annual statements rendered to the insurance departments at the close of the previous year, it will not be necessary for insurance companies to file amended returns under the provisions of Treasury Decision 3220, if in the original returns securities or real estate have been valued on the basis of book or market as reported to the insurance department of the State. (I-6-82; I. T. 1201.)

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Intangible property acquired for tangible property.—

RULING. Held, that intangible property when acquired for tangible property must be taken into account at the value of such intangible property at the date of acquisition. It being assumed that the tangible property before and after transfer had an immediately realizable market value, the value of the intangible property is measured by the then fair market value of the tangible property exchanged therefor and not by the original cost of such tangible property. (C. B. 4, page 395; A. R. M. 131.)

If tangible property, under the foregoing ruling, costing $100,000 in 1914, was worth, in 1920, $50,000, and was exchanged for intangible property, the "cost" to the purchaser of such intangible property would be $50,000. It is assumed

that $50,000 has been lost and should be debited to surplus. If the transaction occurred after January 1, 1917, taxpayers would hardly object to the ruling; if before 1917, it would result adversely to taxpayers unless it could be shown that there was no readily realizable market value, in which case the intangible property could be carried at the book value of the tangible property.

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Improvements in leaseholds.—

RULING. In 1904 the M Company as lessee leased certain property for a term of ten years. Under the terms of the lease the M Company made certain improvements which became the property of the lessor. The lease expired in 1915 and was again renewed.

Held, that the amount invested by the M Company in improvements, if paid out of original capital or surplus, constituted invested capital for the taxable year in which expended, such invested capital to be reduced at the beginning of each subsequent year by an amount equal to the result obtained by dividing the total cost of such improvements by the number of years the lease was to run.

Since the lease under which the improvements were made expired in 1915, the taxpayer had no right nor title under the lease to any asset which constituted a part of such improvements subsequent to that year, not even the right of usage. Therefore, subsequent to 1915 it possessed nothing therein which could be said to constitute invested capital for the purpose of computing excess profits tax under the provisions of the Revenue Act of 1917 or 1918. (C. B. 4, page 366; A. R. R. 384.)

In the foregoing case the lessee, upon renewal in 1915, became the owner, for a limited term, of the improvements. The cost of such improvements, less depreciation to January 1, 1917, was a capital investment. Under the *La Belle Iron Works* case, it would seem that such investment could be included in invested capital. If the improvements were charged off after 1909, it might be in order to file amended returns.

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Cash surrender value of insurance policies.—It has been held[12] that the surrender value of an insurance policy taken out

[12] B. 47-21-1938; O. D. 1100.

by a corporation on the life of a guarantor of a debt cannot be included in invested capital. This ruling is apparently based on the fact that the policy has no asset value in addition to the face value of the debt which is still being carried at its face value. If the debt becomes bad, a claim against the guarantor would replace it. Such insurance is a mere protection and has only a potential value.

If the debt has been charged off and no claim against the guarantor is set up in the books, the surrender value of the insurance policy would be included.

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Discount on bonds.—

RULING. Held, that a corporation which issued bonds at a discount in January, 1900, and elected then to charge such discount to profit and loss for the year of issue and the next two succeeding years, may not now revise its accounts and file amended returns for the purpose of reinstating to invested capital the unexpired portion of such discount and claiming as a deduction from income that portion applicable to each year. (C. B. 4, page 391; A. R. R. 394.)

The foregoing ruling may or may not be sound. It is to be regretted that the Treasury places so much weight on court decisions which are not relevant. The case cited in support of the ruling[13] was brought under the 1909 law, which was not an income tax law, and it did not refer even remotely to invested capital.

The court followed the decision handed down in another case[14] in which it was held in effect that discount on bonds is not an expense until the maturity of the bonds. If the language of the court had the slightest connection with invested capital (it has not), it might be urged that the property purchased with the proceeds of bonds should be set up at the par of the bonds. This principle at one time was considered good accounting practice and was adopted by the Interstate Commerce Commission.[15]

[13] *Chicago & Alton R. R. v. U. S.*, 53 Ct. Cls. 41.
[14] *Baldwin Locomotive Wks. v. McCoach*, 221 Fed. 59, 136 C. C. A. 660.
[15] Montgomery's Dicksee's *Auditing* (revised edition), page 50.

What constitutes invested capital is not settled by bookkeeping entries made in 1900, nor by court decisions interpreting the 1909, 1913, or 1916 laws. In some respects the *La Belle Iron Works* case[16] is controlling because in that case the court discussed the allowable elements of invested capital under the 1917 and 1918 laws. It is a fair inference from the decision that any item of capital investment remaining as at January 1, 1917 (excluding appreciation) will be allowed as invested capital even though the cost may have been written off the books. If discount on bonds is an asset at any time after January 1, 1917, logically it should be such at January, 1, 1917, because prior thereto taxpayers were not on notice that books should be kept in a certain way. It would be grossly unfair, in 1918, to penalize a taxpayer who in 1900 did something entirely legal but which might have been done in some other legal way. Invested capital is not a question of bookkeeping; it is a question of fact.

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When expenditures for intangibles charged off prior to 1917 may be included in invested capital.—Prior to the handing down of any court decisions dealing with the computation of invested capital, the Treasury took the position that development, exploitation, and similar expenses when charged off to expense accounts as incurred could not be restored to invested capital.[17] In the *La Belle Iron Works* case[18] the Supreme Court said, in speaking of exploration and development expenses charged off in prior years, "we assume that a proper sum, not exceeding the cost of the work might have been added to earned surplus on that account." It became obvious that the regulations which specifically permitted the restoration of tangible property written off prior to 1917 were discriminatory. The cost of intangible property of

[16] 41 Sup. Ct. 528.
[17] Reg. 45, Art. 841. See *Excess Profits Tax Procedure,* 1921, pages 159, 179-184.
[18] 41 Sup. Ct. 528.

one taxpayer which still existed at January 1, 1917, was just as much an expenditure for income-producing purposes (sometimes much more so) than the expenditures of another taxpayer for tangible property.

It is evident from the *La Belle Iron Works* case that all forms of appreciation[19] must be excluded from invested capital, but that all forms of cash investment in capital must be included. The inadvertent charging off of intangible capital items prior to 1917 cannot be penalized any more than the charging off of tangible items can be. The changed position of the Treasury is best illustrated in a recent decision whereby publishers who wrote off expenditures to build up subscription lists are permitted to restore all of the items which can be identified.

RULING. The Committee is of the opinion in the matter of the argument of the M Company and the O Company, taxpayers engaged in the publication of newspapers, that moneys expended out of earned surplus or current earnings for the sole purpose of building up the circulation structure may be added to capital invested when proper proof of such expenditures is made and amended returns for prior years have been filed. . . . . (B. 47-21-1937; A. R. M. 141.)

In one case[20] a corporation claimed that it had only nominal capital in 1917 because it had no tangible assets except cash which it did not need. The government claimed that $19,000 expended upon a certain process between 1909 and 1917 "should be taken as a surplus used and employed in the business." The process was found to have substantial value. The court held that the corporation had more than nominal capital. The writing off of the expenditures was not deemed to influence the one fact at issue, viz: What *was* the invested capital as at January 1, 1917?

Contracts.—

RULING. . . . . an unperformed contract to furnish manufactured products represents no rights in tangible property which

[19] Except when January 1, 1914, values can be used.

[20] *Lincoln Chemical Co. v. Edwards*, 272 Fed. 142, Dist. Ct. So. Dist. N. Y., April 19, 1921.

would entitle it to be regarded as deriving its value chiefly therefrom. On the contrary, the value of the contract is of an intangible nature, contingent upon the performance of its terms and the realization of the anticipated profit. The intangible rights under such a contract would, therefore, be subject to the limitation contained in section 207 of the Revenue Act of 1917, and section 326 of the Revenue Act of 1918, in the case of intangible property purchased with corporate stock. (C. B. 3, page 324; O. D. 635.)

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Goodwill.—

RULING. Goodwill in a corporation can not be allowed as invested capital under a claim that a price paid to stockholders by certain individuals was in excess of corporate book value of the stock. Good will must be acquired by direct purchase; it can not be determined by a collateral transaction. (C. B. 4, page 379; A. R. R. 413.)

If an individual acquires substantially all of the stock of a corporation for a price largely in excess of its book value, such excess does not constitute goodwill acquired by the corporation. There has been no change in the price paid for the original assets by the corporation, but merely a change in the stockholders of the corporation. The transaction might be pertinent in a claim for relief on the ground that the earnings of the corporation were abnormal. It would be necessary to find representative corporations in the same line of business whose invested capital is comparable with the purchase price of the shares.

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Patents.—In a recent case[21] it was held that "the value of certain patents for which stock of a corporation was issued must be measured by the cash consideration paid therefor by certain incorporators of the company just prior to incorporation."

The peculiar feature about this case was that the original owner had neglected to develop the patents in question. On sale to a syndicate which actively developed their use, the

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[21] C. B. 4, page 369; A. R. R. 396.

latent value of the patents became apparent, and on this developed value the claim for paid-in capital was based. The claim was disallowed.

CHAPTER IX

INADMISSIBLE ASSETS

The new law defines inadmissible assets in the same terms as the 1918 law. However, the stocks of two types of corporations which were formerly inadmissibles are taken out of that class and made admissible assets. The change arises from a new provision in the 1921 law which affects the deductibility of dividends in arriving at the net income of the recipient corporation.

Inadmissible assets are defined as follows:

LAW. Section 325. (a) . . . . **The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income. . . . .**

The deduction of dividends allowed a corporation in computing its net income is stated as follows:

LAW. Section 234. (a) . . . . **(6) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217; . . . .**

Dividends received from a foreign corporation which does *not* derive more than 50 per cent of its gross income from sources *within* the United States are not deductible. Hence, when the dividends are not deductible the stock of such foreign

corporation becomes an admissible asset. Under the 1918 law, if even a small part of the income from a foreign corporation was derived from sources within the United States, and thus rendered subject to taxation, the dividends from such foreign corporation were deductible in arriving at the net income of the corporation receiving them, and the stock of such foreign corporation was an inadmissible asset.[1]

The stocks of domestic corporations entitled to the benefits of section 262[2] are also fully admissible because dividends from such corporations are not deductible by the recipient corporations.

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Bonds not obligations of the United States.—Securities which are in the nature of government bonds, but which are not direct obligations of the United States, are inadmissible assets if the income therefrom is non-taxable.

Ruling. Since the income from Federal land bank bonds is tax free and since such bonds are not obligations of the United States, they are inadmissible assets within the meaning of section 325 (a) of the Revenue Act of 1918, and should be so treated in computing the invested capital of a corporation. (B. 42-21-1875; O. D. 1069.)

For similar reasons, 4 per cent bonds of the government of the Philippine Islands are held to be inadmissible assets,[3] as are bonds of Porto Rico and Hawaii.[4]

School warrants issued by a county of a state are inadmissible assets,[5] except where they have been cashed by a bank for the accommodation of teachers and where no remuneration was received for that service),[6] as is the principal of municipal assessments issued for improvements.[7]

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[1] **[Former Procedure]**. The 1918 law [section 234 (a-6)] permitted as a deduction "Amounts received as dividends from a corporation which is taxable under this title upon its net income. . . . ."

[2] See page 1324.

[3] B. 40-21-1857; O. D. 1057.

[4] B. 38-21-1836; O. D. 1044.

[5] C. B. 4, page 363; O. D. 929.

[6] B. 45-21-1915; O. D. 1096.

[7] B. 34-21-1778; O. D. 999.

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Reserve for bad debts affects computation of admissible assets.—In the case of a corporation reporting for the calendar year 1921, the reserve for bad debts at the beginning of 1921 has not been allowed as a deduction in computing net income, and should therefore not be deducted from accounts receivable. At the end of 1921, however, any *addition* to the reserve during 1921 which has been allowed as a deduction from gross income must be deducted from accounts receivable. Since 1921 is a year of transition, so far as the reserve for bad debts is concerned, the reserve must be treated differently at the beginning of 1921 than at the end of 1921. However, in subsequent calendar years, no computation of inadmissibles will be necessary, because the excess profits tax law is not in effect after December 31, 1921.

Valuation of assets for purposes of inadmissible computation.—The new law[8] provides for valuation of assets in accordance with sections 326 and 331. The 1918 law provided for the valuation of assets in accordance with sections 326, 330, and 331 of that act. Reference to section 330 in the 1918 law is not carried forward, since section 330 was eliminated in the new act. Section 330 of the 1918 law provided for the valuation of assets on the same basis in the prewar period and taxable year, but as no computation of prewar invested capital is necessary in determining excess profits tax at 1921 rates, the section is no longer necessary.

This method of valuation would still apply, however, in the case of any corporation which received net income of $10,000 or more from government contracts in 1921. In such cases the provisions of the 1918 law are to be followed and it becomes necessary to compute the prewar invested capital.[9]

[8] Section 325.

[9] Section 301 (b).

Page 211

Fiscal year corporations—changes in admissibles due to computation under two laws.—The percentage of average inadmissible assets to average total admissible and inadmissible assets is to be applied in determining the reduction of invested capital necessary because of the possession of inadmissible assets. The total average assets will ordinarily be ascertained from the balance sheets at the beginning and end of the taxable year. In the case of a corporation reporting for a fiscal year ending in 1921, however, two computations are made,[10] one under the 1918 law and one under the 1921 law. Due to a different classification of assets under the two laws (such as stocks of certain foreign corporations and those under section 262[11]), the average inadmissibles will be different in the two computations, the resulting percentage will be different, and the adjustment of invested capital required will also be different.

Under the 1918 law additions to a reserve for bad debts were not deductible. Accordingly, since such reserve, for tax purposes, was considered as a part of surplus, accounts receivable were not reduced by the amount of such reserve in making the computation of admissible assets.[12] However, the 1921 law permits additions to a reserve for bad debts to be deducted in computing net income. Therefore, in the computation of admissible assets under the 1921 law, the reserve for bad debts would be deducted from accounts receivable, the converse of the procedure followed in making the computation under the 1918 law.

Inadmissible assets of dealers in securities.—Dealers in securities cannot include in invested capital any securities which come within the definition of inadmissible assets, even though their business consists of dealing in such securities.

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[10] Section 335 (a).
[11] See page 1324.
[12] See *Excess Profits Tax Procedure* 1921, page 198.

RULING. A corporation which is a "dealer in securities" within the meaning of article 1585 of Regulations 45 is not entitled to include in invested capital amounts invested in inadmissible assets, even though such assets are held as merchandise, except under conditions entitling it to the benefits of article 817 of Regulations 45. (I-1-14; I. T. 1155.)

CHAPTER X

ADJUSTMENT OF CAPITAL, SURPLUS, RESERVES AND LIABILITIES

Page 226

Capital stock paid for in instalments.—

RULING. Subscription payments made in instalments, when a corporation increased its capital stock, are properly included as invested capital from the date of receipt. So-called interest paid to the subscribers on the installment payments from the date of receipt to the date of issuance of the stock certificates is not deductible. (B. 32-21-1765; O. D. 991.)

Page 238

Surplus arising from revaluations.—The opinion of the Solicitor of Internal Revenue (B. 43-21) is fully discussed on page 1620. The author's contentions as to the date when realized appreciation should be included in invested capital, and the illegality of taxing distributions of surplus accrued prior to March 1, 1913, are unchanged. This subject, including the Supreme Court decision in the *La Belle Iron Works* case, is discussed further on page 1620 *et seq.*

Page 233

Reserves for bad debts.—The 1921 law includes among allowable deductions additions to reserves for bad debts. This has little effect on the excess profits tax, since the tax is repealed effective December 31, 1921. Reserves for bad debts at the beginning of the taxable year 1921 are included in in-

vested capital. The effect on the computation of the deduction for inadmissible assets is dealt with in Chapter IX of this appendix.

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Deductions for depletion.—

Ruling. Held, that a mining corporation, in computing its invested capital for the purpose of the war excess profits tax, is required to reduce its earned surplus by the amount of its sustained depletion to the beginning of the year for which the tax is computed.

In the ruling of the Committee on Appeals and Review, there appears the following opinion of the Solicitor of Internal Revenue, dealing with the taxpayer's contention:

It is contended by the taxpayer that, owing to the peculiar character of mining properties, there is no depletion so long as "discovery and development outrun depletion," and that any actual prior depletion is taken care of by the provision for the valuation of tangible property paid in as of January 1, 1914.

The peculiar character of mining property was well stated in *Stratton's Independence v. Howbert*, 231 U. S. 399, 413, as follows:

The peculiar character of mining property is sufficiently obvious. Prior to development it may present to the naked eye a mere tract of land with barren surface, and of no practical value except for what may be found beneath. Then follow excavation, discovery, development, extraction of ores, resulting eventually, if the process be thorough, in the complete exhaustion of the mineral contents so far as they are worth removing. Theoretically, and according to the argument, the entire value of the mine, as ultimately developed, existed from the beginning. Practically, however, and from the commercial standpoint, the value—that is, the exchangeable or market value—depends upon different considerations. Beginning with little, when the existence, character, and extent of the ore deposits are problematical, it may increase steadily or rapidly so long as discovery and development outrun depletion, and the wiping out of the value by the practical exhaustion of the mine may be deferred for a long term of years.

This statement contains the answer to the contention of the taxpayer. The reason that in the case of mines the Supreme Court has consistently held that no deduction for depletion or depreciation in computing net income can be allowed, in the absence of statutory authority, is that by reason of the fact that discovery and development may outrun depletion there is not necessarily any actual decrease in the value of the taxpayer's property, and, therefore, the entire net receipts may well be considered income. The rule is not new but has come down to us from the common law of England.

This, however, does not negative the fact that the removal of each ton of ore depletes pro tanto the ore originally known to exist in the mine and which was originally valued. The maintenance or increase of the original value is solely due to the fact that the loss of value through depletion is equalled or exceeded by the appreciation in value through discovery or development. To treat the entire net income as earnings and as constituting earned surplus in the succeeding year when not distributed by the company would, therefore, to the extent of the depletion actually sustained during the year, be to permit the inclusion of appreciation in the value of the mine, by reason of development and discovery, in invested capital, a thing which is not contemplated by the statute nor permitted by the regulation. (C. B. 4, page 385; A. R. R. 517.)

The foregoing opinion is sound in so far as it relates to 1918 and subsequent years. It would appear, however, that an attempt is made to apply old court decisions and the provisions of the 1918 law to a specific section of the 1917 law. Section 207 of the 1917 law provides that appreciation at January 1, 1914, may be included in invested capital up to the par value of stock specifically issued for tangible property. Assume that a mining company issued $1,000,000 in stock for property worth $500,000; that on January 1, 1914, one-half of the mineral content was exhausted; that the value of the remaining half was $1,000,000. There is nothing in the law to indicate that in computing invested capital for 1917, depletion of $250,000 (that being one-half of the original cost) must be deducted from the value of the property on January 1, 1914; on the contrary, the framers of the law went to a great deal of trouble to insert a specific provision that appreciation up to the par value of the stock should be included in invested capital.

If they had intended that depletion should be deducted, it would have been extremely easy to provide for it. The section is perfectly clear as it stands and is not affected by the decision in *Stratton's Independence v. Howbert*,[1] which was handed down in 1913 under the 1909 (cash basis) law. The change made in the 1918 law merely carries out the inten-

[1] 231 U. S. 399, 58 L. Ed. 285, 34 Sup. Ct. 136.

tion to eliminate appreciation as an element in invested capital. The Treasury cannot change the 1917 law in one of its few unambiguous sections.

Page 240

Reserves for depletion.—A further illustration of the use of the depletion reserve and of the surplus arising from the revaluation of mines, is given in Chapter XXXIII of the income tax section of this volume.

Page 248

Decrease in invested capital by payment of federal taxes.—The author wishes to reiterate the comment made in the 1921 edition of *Excess Profits Tax Procedure.*

The position of the Treasury is equivalent to the imposition of a tax in a past year which was not authorized by Congress. The law defines invested capital in a specific and technical manner. The deductions are limited. If any doubt exists, the Treasury cannot successfully decide the doubt in favor of the government.[2] If in 1921 the government claims that an additional tax is now due, arising from net income for 1917, it cannot also be claimed that as of some date in 1918 the amount was due *and payable* and that there was an actual diminution in invested capital *at that time.* There was no diminution until 1921. The corporation had in hand, without restriction or lien, the full amount until some time in 1921. To say that it did not have it, is to run counter to the spirit and letter of the law.

It is a decrease of invested capital by fallacious construction and not by fact.

Page 250

Tax overpaid—included in invested capital.—

RULING. A taxpayer made an overpayment of income taxes for the year 1917 in 1918, which amount was refunded to him in the year 1921.

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[2] *Gould v. Gould,* 245 U. S. 151, 62 L. Ed. 211, 38 Sup. Ct. 53.

The question presented is whether the taxpayer may include in its invested capital the amount so refunded for the calendar year 1921.

Held, that under the provisions of article 845 of Regulations 45 the amount of tax overpaid for 1917 and refunded may be included in the invested capital of the taxpayer for 1918 and subsequent years. (B. 43-21-1889; O. D. 1079.)

The principle followed in the foregoing ruling must be, that as of the time of overpayment a correcting entry would debit the government and credit earned surplus. It is questionable how far corrections in the accounts of past years should be carried.

Reserves of insurance companies.—Article 870 of Regulations 45 was amended by T. D. 3153, dated April 9, 1921, to read as follows:

REGULATION. The reserve funds of life insurance companies, the net additions to which are deductible from gross income under the provisions of section 234 of the statute, can not be included in computing invested capital. The like reserve funds of insurance companies, other than life insurance companies, may be included in computing invested capital. See sections 325 and 326 (a) (3) and (b) and articles 569 and 814. (Reg. 45, Art. 870, as amended by T. D. 3153.)

In view of the change of the method of taxing the income of life insurance companies for 1921 and subsequent years, this regulation will be no longer effective. For further discussion of this change, see Chapter XXXVIII of the income tax section of this volume.

CHAPTER XI

CHANGES IN INVESTED CAPITAL

Page 256

Surplus from sale of capital assets may be additions to invested capital during year.—In a recent ruling[1] the Treas-

[1] B. 43-21-1878; L. O. 1073. See page 718.

ury reiterates its position that realization of appreciation of assets accrued before March 1, 1913, are earnings or profits of the year when realized, rather than realizations of capital. The ruling is fully discussed elsewhere. In the *La Belle Iron Works* case[2] the Supreme Court declined to permit the inclusion of unearned or unrealized increment, in invested capital, but emphasized the right of taxpayers to include all items of cash or equivalent. The Treasury, in effect, says that appreciation at March 1, 1913, cannot be included in invested capital until the first day of the year following its realization. "A" sells capital assets on January 2, 1918, and realizes $100,000 above March 1, 1913, value. The excess is not taxable. It is allowed as invested capital from and after January 1, 1919. "B" sells and realizes on December 31, 1917, and may add $100,000 to invested capital the next day. The Treasury's position is not in line with the definition of invested capital in the laws and as discussed by the Supreme Court in the *La Belle Iron Works* case.

Invested capital must be paid in or arise from earned surplus. Earned surplus is taxable surplus, that is, it arises from current earnings. Realization of appreciation is not earned surplus. The only limitation on the dates when the items of invested capital are to be included, refers to earned surplus. All other items are included on the dates when paid in.

In a recent case[3] a taxpayer paid $500 for property which was worth $695 on March 1, 1913, and which was sold in 1916 for $13,931.22. The court referred to the March 1, 1913, value as "his capital investment." If it had been a corporation and the sale had taken place in 1917, can it be assumed that the $195 appreciation prior to March 1, 1913, referred to as "capital," would follow the same course as the $13,236.22 taxable gain arising after March 1, 1913? Is it not more reasonable to assume that the court would direct

[2] 41 Sup. Ct. 528.
[3] *Goodrich v. Edwards*, U. S. Supreme Court, March 28, 1921.

that there be credited to capital account on the day of realization, $695, and to current earnings, the sum of $13,236.22? Invested capital would be increased by $195 on day of realization, and by the net earnings at the end of the year, including the $13,236.22.

The inhibition against the inclusion of unearned increment or appreciation in invested capital ceases the moment the appreciation is converted into the equivalent of paid-in capital; when it becomes actual instead of prospective.

Furthermore, no formula has been devised which reasonably can be applied to the segregation of March 1, 1913, values into capital and accumulated profits. The revenue laws and the courts use the words, "gain, profits and income," interchangeably. It has been immaterial whether a taxpayer's capital on March 1, 1913, represented cost to him or whether it included appreciation. But if the Treasury is right in its contentions, it is important to revise all values at March 1, 1913, in order to reduce the apparent appreciation, at that date, and set up the maximum amount as cost. In many cases, so-called appreciation at March 1, 1913, is merely restoration of capital assets theretofore charged off. When taxpayers are not able to sustain the written-up figures, invested capital is limited to the book values. The segregation of subsequent realization of all or any part of the appreciation is not justified by the law. If an asset at March 1, 1913, is not allowed as invested capital because it represents unrealized appreciation, the theory of invested capital requires that on the date of realization it automatically be included in invested capital. It is not a gain or profit to be related to the period after March 1, 1913; what it was before that date is not an element in the computation of invested capital.

In this connection, too, it is important to consider Section 201 of the 1921 law and article 1543 of Regulations 62 interpreting that section. The regulation after stating that "Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase of value

of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition) is not a dividend within the meaning of the Act," goes on to state that "the provisions of the preceding sentence shall be applied uniformly to cases arising under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, as well as the Revenue Act of 1921." It is clear from the law, and Regulations 62 as above quoted, evidently so hold, that appreciation in value of property prior to March 1, 1913, is deemed to be capital at that date and that subsequent realization does not represent a profit of the year of realization. Consequently, the 1922 regulations would appear to overrule A. R. M. 51 (C. B. 2, page 297), quoted on page 256 of *Excess Profits Tax Procedure,* 1921, and appreciation accrued prior to March 1, 1913, would therefore be allowable as an addition to invested capital from the date of realization and not merely from the beginning of the following taxable year.

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Computation of average invested capital.—It should be noted that, as 1920 was a leap year, adjustments of invested capital should be made on the basis of 366 days.[4]

Page 264

Effect of ordinary dividend.—

RULING. Held, that the expression, in a declaration by the directors of a corporation, that a dividend is "payable as convenient to the funds of the company" creates a condition precedent. Dividends so declared are not necessarily to be considered payable as of the date of the declaration, and in such a case the invested capital should be adjusted as of the date the dividend is made payable rather than the date it is declared. (C. B. 4, page 396; A. R. R. 408.)

Article 858, of Regulations 45, states that when no date is set for the payment of dividends, the date when they are declared will be considered also the date when they are payable. The date of declaration can hardly be regarded in determin-

[4] C. B. 4, page 396; O. D. 822.

ing tax liability. If a dividend is declared "payable as convenient," an administrative decision by the officers of the company is necessary before stockholders have the right to demand payment. Until such decision is made, the dividend is not taxable to the stockholders, and it has no effect on invested capital.

Dividend paid in interest-bearing notes.—

RULING. Where a corporation issues interest-bearing notes to its stockholders in lieu of a cash dividend, invested capital should be reduced as of the date of the notes, provided the dividend was not declared from current earnings. (B. 42-21-1876; O. D. 1070.)

If the notes were subordinated to all the liabilities of the corporation and interest payments were conditional, it is possible that invested capital might not have to be reduced.

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Accruals of taxes should not be deducted from invested capital.—In Bulletin 30-21, the Treasury merely reiterates the principle laid down in article 857[5] and attempts to justify it under accounting principles. It cannot be disputed that "expenses of a year should be charged against the income of that year," but it is difficult to see what this has to do with the computation of invested capital. In the *La Belle Iron Works* case, the Supreme Court observed that book entries could not affect the highly technical and arbitrary definitions of invested capital which are found in the laws. The court says that invested capital consists of "investment" plus accessions, and emphasizes the element of cost as distinguished from accruals of value. Certainly an estimated accrual of a future liability which is not, for tax purposes, deductible from the current earnings, is not a reduction of invested capital. The court wisely disallowed unrealized appreciation as an addition to invested capital; it is a fair assumption that it will be

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[5] *Excess Profits Tax Procedure*, 1921, page 266.

equally wise in overruling the Treasury in its attempt to reduce invested capital unduly.

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Corporation in process of liquidation.—

RULING. The invested capital of a corporation whose assets are in the custody of trustees in liquidation should be computed in the same manner as in the case of an active corporation, making due allowance for any amount of capital assets which have been liquidated and returned to the stockholders during the taxable year. The trustees may, owing to abnormal conditions affecting the capital or income, make application for assessment in accordance with sections 327 and 328 of the Act. (B. 27-21-1720; O. D. 969.)

Compliance with this ruling should be a simple matter, because trustees in liquidation are required to file corporate returns which give all the necessary information for the periods prior and subsequent to their appointment.

CHAPTER XII

PRE-WAR INVESTED CAPITAL

Except when there is net income of $10,000 or more from government contracts, the ascertainment of pre-war invested capital is not a factor in returns for the calendar year 1921.

What has been said with reference to the effect upon pre-war invested capital of adjustments of net income of prior years by revenue agents,[1] applies equally to proposed adjustments of assets resulting from recomputations of depreciation. If depreciation for prior years is increased, invested capital of the pre-war period is correspondingly decreased. In considering adjustments of 1917 and 1918 returns, the effect on invested capital of the pre-war years 1911, 1912, and 1913, should always be kept in mind.

[1] See page 1600.

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Goodwill and patents.—

RULING. Where the cost of patents has been charged against surplus or otherwise disposed of in such a manner as not to benefit the taxpayer in computing his net income since January 1, 1909, any amount so written off may be restored in computing the invested capital if it be shown to the satisfaction of the Commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets. (Extract from Tax Reviewers' Recommendation 1, quoted in C. B. 4, page 392; A. R. R. 436.)

Such adjustments necessarily affect pre-war invested capital, if the amounts were written off during the year 1911, 1912, or 1913.

Limitation on intangibles.—In computing invested capital for pre-war years, under the 1917 law, the inclusion of intangibles at not to exceed 20 per cent of the capital stock outstanding at the beginning of the year, will have to be remembered, whereas under the 1918 and 1921 laws the limitation is 25 per cent. It is well to bear in mind that the limitation applies separately to each year, particularly where changes in the amounts of issued stock and in the amounts of treasury stocks (which are deducted in arriving at outstanding stock) have occurred in each of the pre-war years.

CHAPTER XIV

CONSOLIDATED RETURNS OF AFFILIATED CORPORATIONS

General

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Consolidated returns[1] for the calendar year 1917 or for fiscal years ended therein were not specifically called for in

[1] The reader who is desirous of a more detailed discussion of the accounting aspects of consolidated balance sheets and income statements, is referred to Chapter XVIII of the author's *Auditing Theory and Practice* (third edition) in which this subject is treated at length.

the 1917 law, but were permitted under Treasury regulations. In order to remove any doubt as to the legality of the Treasury's action, a section has been included in the 1921 law to ratify the Treasury's procedure.

LAW. Section 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

A partnership may be included in a consolidation made under the 1917 law, whereas under the 1918 and 1921 laws such inclusion is not permitted, except as provided in section 240 (d) of the 1921 law (see page 1629).

Consolidated returns optional after January 1, 1922.—The 1921 law makes the consolidated returns provision of the 1918 law applicable to the returns of taxable years beginning before

January 1, 1922, but makes consolidated returns optional after that date.

LAW. Section 240. **(e) Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.**

For taxable years beginning on or after January 1, 1922, the following provisions apply.

LAW. Section 240. **(a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.**

Affiliated corporations whose taxable years commence on or after January 1, 1922, are given the option of filing separate returns or of filing a consolidated return. An election once having been made, no change in the basis used can be made without obtaining permission from the Commissioner.

If consolidated returns are made, intercompany transactions which involve profits or losses can be freely made without affecting the net taxable income.

Two important points should be considered in making the decision: (a) losses of affiliated companies, and (b) loss of specific credits.

(a) The loss sustained by an affiliated company included in a consolidation is applied against the net income of the other member or members of the group, thereby reducing the net taxable income. If a consolidated return were not rendered, it is true that under certain conditions, as contained in section 204,[3] taxpayers may deduct losses sustained in one

[2] For a definition of affiliated corporations, see *Excess Profits Tax Procedure,* 1921, page 308.

[3] See page 1021.

year from the net income of the succeeding year or years. However, a consolidation makes it possible to apply a loss against any net income in the *current year*. Since corporation earnings and losses do not run consistently from year to year, and since one corporation may lose year after year, it seems that consolidated returns are desirable.

(b) The question of the specific credit also has a direct bearing on the advisability of consolidation.

LAW. Section 236. **(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and . . . .**

A consolidation is entitled to but one specific credit of $2,000, whereas, if separate returns are rendered, each corporation in the group having a net income of less than $25,000 may claim a specific credit of $2,000, which, taxed at 12½ per cent, means a saving of $250 per corporation.

The framers of the 1921 law evidently thought that the option of rendering separate returns opens the possibility of evasion of taxation by intercompany manipulations. For this or for some other reason, a provision has been inserted which empowers the Commissioner to make consolidated returns for certain enterprises.

LAW. Section 240. . . . . **(d) Provided, That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.**

REGULATION. Subdivision (d) of section 240 provides that in any case of two or more related trades or businesses (whether incorporated or not, and whether organized in the United States or not), owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades or businesses, in any proper case, for the purpose of making an ac-

curate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses. This provision relates not to the *payment* of taxes, but to the determination of the true income of related trades or businesses and thus indirectly to the *amount* of taxes which may be due under Title II and Title III of the statute. (Art. 637.)

It is unfortunate that the foregoing provision of the law appears at the end and as a part of a paragraph which deals with corporations entitled to the benefits of section 262.[4] Taxpayers may infer that the power granted to the Commissioner is limited to corporations embraced in section 262. A careful analysis of this provision demonstrates that it could not so apply because it contains the stipulation "whether organized in the United States or not," which could not apply to a corporation which qualifies under section 262. The power evidently is granted to the Commissioner in order to determine the true income, whether or not the businesses are affiliated within the meaning of section 240.

The power given to the Commissioner to require consolidated returns for the express purpose of ascertaining the true net income of affiliated interests, applies to any form of business, whether individual, partnership, or corporation.

To sum up, taxpayers may render consolidated returns if they so elect; their right to render separate returns may be challenged by the Commissioner.

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Corporations classed under section 262 excluded.—Domestic corporations which derive the major portion of their income from sources within the territorial possessions of the United States are, under the provisions of section 262 of the 1921 law, treated as foreign corporations and cannot be included in a consolidated return, by the taxpayer, although the Commissioner may consolidate the returns to ascertain the true income.[5] Where equity demands consolidation, taxpayers

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[4] Section 262 deals solely with citizens and domestic corporations operating in possessions of the United States. See Chapter XXXVI.

[5] *Supra*, section 240 (d).

should request the Commissioner to exercise his discretion to require consolidated returns.

Law. Section 240. . . . . **(d) For the purposes of this section a corporation entitled to the benefits of Section 262 shall be treated as a foreign corporation.**

Certain government contract corporations.—Under section 240 (a) of the 1918 law, an affiliated corporation "organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts, made between April 6, 1917 and November 11, 1918, both dates inclusive," could not be included in a consolidation under that law. This inhibition has not been carried forward into the 1921 law and it is therefore possible to include such corporations in a consolidation after January 1, 1922, if they meet the tests of affiliation prescribed by section 240 (c)[6] of the 1921 law.

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"Substantially all the stock" interpreted.—The following rulings, which deny permission to consolidate, are illustrative of the Treasury's interpretation of this phrase in cases where there is less than 95 per cent stock control without substantial intercompany transactions.

Rulings. Held, that where 19 per cent of the stock of a corporation is owned by minority interests, 13 per cent of which is owned unconditionally by one of the officers, and where 39 per cent of the stock of another corporation is held by minority interests, 10 per cent of which is held unconditionally by a different officer, and in each instance the officer has no other interest in the otherwise controlled corporations, there should be no consolidation in the years 1917, 1918, and 1919 for tax purposes. (C. B. 4, page 314; Digest A. R. R. 448.)

Held, that stock control of 69.04 per cent in the year 1918, without intercompany operating transactions or artificial intercorporate relationship, is insufficient to authorize a consolidated tax return for that year. (C. B. 4, page 309; Digest A. R. R. 378.)

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[6] See Appendix C.

The last ruling intimates that: (1) if the companies had been operated as one business enterprise, and (2) if profits could have been shifted, a consolidated return should be made. This is sound.

The author is of the opinion that the Treasury has given too much weight to the size of the minority interest. A 5 per cent minority have the same rights as a 30 or 40 per cent minority. The primary tests are: (1) Have the companies been operated as one enterprise? (2) Could the profits have been shifted in any material extent?

In another case a corporation owned all of the stock of a subsidiary, but deposited all of such stock with a trust company as collateral to cover the issue of its preferred stock. It retained, during the period of the agreement, no control therein. A consolidation of the parent and subsidiary company was denied.[7]

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Interpretation of the phrase, "the same interest."—Separate companies are sometimes the outgrowth of one business which has been divided in order to distribute an estate satisfactorily. Before the distribution three beneficiaries may jointly own three businesses, in which event the law calls for a consolidated return. After the distribution the same interests own precisely the same assets. Conditions do not permit that each business be divided into three equal parts; therefore the proportions—not the same interests—change. If the change inadvertently results in an inequitable tax, a consolidated return should be permitted or relief should be granted to the corporation which suffers unduly.

A ruling issued in 1919,[8] which in effect substituted the words "in substantially the same proportions" for the words of the law, "the same interests," should be reversed.

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[7] B. 43-21-1888; A. R. R. 641.

[8] Dated April 11, 1910. See *Excess Profits Tax Procedure*, 1921, page 313.

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Specific credit in case of consolidated return.—

LAW. Section 240. . . . . **(b) There shall be allowed in computing the income tax, only one specific credit computed as provided in subdivision (b) of section 236.**

Under the 1918 law one specific credit of $2,000 was allowed in computing the net income of a consolidation. In making consolidated returns for taxable years beginning on or after January 1, 1922, this specific credit will be permitted only if the net income of the consolidation does not exceed $25,000.

Page 317

Transfer of assets between affiliated companies not considered a replacement.—

RULING. Where one of an affiliated group of corporations which files a consolidated return established a replacement fund in accordance with the provisions of Article 50, Regulations 45, the expenditure of the replacement fund so established to replace a steamship in kind is not a replacement within the meaning of that term, when the steamship acquired to replace the one lost was acquired from another of the affiliated corporations. (B. Digest 48-21-1942; A. R. M. 142.)

In refusing to consider the purchase of assets of one affiliated company from another affiliated company in the same group as constituting a "replacement" as defined in articles 49 and 50, of Regulations 45, the Treasury is maintaining its contention that a group of affiliated companies must be considered as an integral whole.

Page 323

Distribution of the tax among the subsidiaries.—The question frequently arises as to the most equitable method of distribution to affiliated companies of the total tax for which a consolidation is liable. The Treasury has suggested a method of apportionment based on net income.[9]

As an alternative method which may work substantial

[9] See *Excess Profits Tax Procedure,* 1921, page 323.

justice in certain cases, it is suggested that the tax may be apportioned on the basis of the tax which would have been paid by each company had separate returns been filed. By this method, if there is a saving in tax by the consolidation, all of the companies receive a share of the benefit.

EXAMPLE

Total tax payable by parent or principal reporting company $100,000

Tax computed separately:

Company	Separate Tax	Percentage	Apportionment of Total Tax of Consolidation
A..........	$ 12,000	10%	$ 10,000
B..........	60,000	50%	50,000
C..........	48,000	40%	40,000
	$120,000	100%	$100,000

Should the consolidation result in the payment of a larger tax by the group than would have been payable had each company filed a separate return, minority interests, if any, might have cause for complaint if their proportion of the tax exceeds the amount which their company would have paid had it filed a separate return.

ALLOCATION OF TAX WHEN PARTNERSHIPS ARE INCLUDED IN CONSOLIDATION.—When partnerships and corporations are both included in the consolidation, under the 1917 law, the Treasury considers two "groups," viz.:

1. Partnerships
2. Corporations

and first allocates the tax on the basis of the net income and invested capital assignable to *each group*. The tax thus allocated is then apportioned on the same basis within each group.

RULING. . . . . While the units of the two groups (units of the partnership group here mean the individual partners) will pay their *income taxes* at different rates, the units of the same group will pay their *income taxes* at the same rates, and if the excess profits tax is allocated to each group, according to the invested capital and net in-

come assignable to the group, all difficulties disappear and the tax is equitably allocated.

It is held, therefore, that where corporations and partnerships are consolidated the excess profits tax should be allocated to the partnerships as a group according to the invested capital and net income assignable to the partnership group. After the proper amount of the excess profits tax has been allocated to the partnership group, article 78 may then be applied within the partnership group as it is now applied within the corporation group. (I-3-37; L. O. 1083.)

Page 327

Pre-war invested capital.—The Committee on Appeals and Review has issued a memorandum,[10] explanatory of articles 802 and 869 of Regulations 45, which deals with the computation of pre-war invested capital and income of corporations affiliated in 1917 or 1918 whose affiliations in the pre-war years were not the same as in the taxable years 1917 and 1918.

Ruling. . . . . The Committee is accordingly of the opinion that there can be taken into consideration in the prewar years only such corporate units for the purpose of determining average prewar income and average prewar invested capital as may be properly consolidated into one corporate unit for the taxable year 1917 or 1918.

This ruling adds little to the articles in question, except by inference. Article 802 merely deals with a case such as the following:

Corporations in existence in pre-war period	Corporations affiliated in taxable year
A	A
B C	B C D E
D (unaffiliated)	
E (unaffiliated)	

In a case such as the above, where A, B, C, D, and E are affiliated in the taxable year, but where only A, B, and C were affiliated in the pre-war period, D and E being separate corporations subsequently affiliated with A, the article provides that the comparative pre-war net income is to be arrived at by

[10] C. B. 4, page 361; A. R. M. 116.

adding that of the group, A, B, C, to the separate net incomes of D and E. Similarly with invested capital. A. R. M. 116 confirms this procedure.

One oversight in the Committee's ruling is patent. If in the pre-war period corporation A had a subsidiary B, which was, say, a selling organization for A's product, and if, since the pre-war period, B has been dissolved and its activities carried on as a *branch* of A, then it is not correct to limit the number of pre-war units (2) to the number affiliated in the taxable year (1). The pre-war comparative of A is A plus B.

As a further illustration, assume in the taxable year three affiliated corporations (two having been sold since the close of the pre-war period but before the beginning of the taxable year). In the pre-war period five corporations were affiliated, because four were owned by a holding company. The procedure in such a case, under the ruling, is as follows:

Corporations in existence in pre-war period	Corporations affiliated in taxable year
A	A
B C D E	B C
	D (unaffiliated)
	E (unaffiliated)

According to the ruling, the pre-war comparative net income and invested capital will be that of A, B, and C, excluding D and E. That is to say, an artificial cleavage must be made in the pre-war affiliated group. However, no attempt is made in the ruling to indicate the procedure for determining the pre-war income and invested capital of the group, A, B, C. The difficult point left unsolved by the Committee is how to eliminate D and E from the affiliated group, A, B, C, D and E. Is the elimination to be made merely by treating the investment in the stock of D and E on A's books as inadmissible assets? Or, should the investment accounts be eliminated from the balance sheet entirely; and if so, how? The illus-

trations given above are the simplest possible; many more difficult combinations occur in actual experience. The intricacies of the problem can best be gauged by the perusal of a recent paper on this subject.[11]

Each case in which pre-war affiliations were not the same as in the taxable year must be dealt with on its own merits. The author cannot lay down any hard-and-fast rule which will fit all cases; neither should the Treasury attempt to do so. The method used must be that which is "necessary to place the computation of the invested capital for such pre-war year on the basis employed in determining the invested capital for the taxable year."[12] The important word is "*basis*," and that basis must be one which will result in a true comparison between the pre-war years and the taxable year.

[Former Procedure]

RULING. The M Company and the O Company were engaged in entirely dissimilar enterprises with no artificial distribution of profits or arrangement of financial relationship to assign to either a disproportionate share of net income or invested capital.

Recommended, that they be authorized to file separate corporate tax returns, notwithstanding that the M Company owned all the capital stock of the O Company and that more than 50 per cent of the sales of the latter company were made at market prices to the former company. (B. Digest 38-21-1834; A. R. R. 624.)

Under the 1918 law the foregoing case would have been decided otherwise, as the 100 per cent stock ownership would have necessitated a consolidated return.

CHAPTER XV

INVESTED CAPITAL IN SPECIAL CASES "THE RELIEF SECTIONS"

Page 331

The 1921 law does not change the relief provisions of the 1918 law, except that section 328 (a) provides that in the

[11] Walter A. Staub, "Consolidated Returns," in *The Federal Income Tax* (Columbia University Press, 1921).

[12] 1918 law, section 330.

case of a corporation coming within the provisions of section 262[1] (which deals with income received by domestic corporations from sources within possessions of the United States), neither the taxpayer nor the representative corporations shall be entitled to the specific exemption of $3,000 when the tax is computed.

The administration of this section of the law is and must be confidential. Therefore, the rulings which have been published since the publication of *Excess Profits Tax Procedure, 1921*, do not throw any additional light on this subject.

As a general rule the published decisions merely state the reasons why an application should or should not be granted. The relief granted is not indicated.

In 1918, the Treasury published statistics of corporate earnings as Senate Document No. 259; it is presumed that similar compilations will be issued from time to time. Such statistics should aid taxpayers in ascertaining the probability of relief.

Selection of representative concerns.—The relief sections were designed by Congress to grant relief. Congress anticipated that unusual cases would arise to which a general rule could not be applied. Consequently the Commissioner was vested with very broad powers.

When a taxpayer has established a meritorious case for relief the Commissioner should select comparatives (representative corporations) which will carry out the language and intent of the law.

When discretionary powers[2] are given to an administrative officer, he should not bind himself by restrictive rules.

The author again quotes Senator Simmons' statement which shows the spirit in which Congress intended that the relief sections should be administered.

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[1] See page 1324.

[2] For distinction between discretionary and ministerial powers, see 29 Cyc. 1433, 1442-4.

The general opinion of the conferees and of the Department, and I concur in that opinion, is that the amendment as redrafted broadens rather than restrains the powers of the Commissioner in the matter of relief against injustice, inequality, and discrimination. . . . .

They (referring to the business interests of the country) may know that there is some provision here by which the Commissioner can help them in case of difficulties of the kind I have described, but I do not think they have yet come to realize the breadth of the discretion which is lodged in the Commissioner in this amendment and what it may be worth to them under the conditions which now confront us.[3]

The author's experience is to the effect that all applications for relief are carefully considered, and that at the present time every effort is being made to administer the relief sections as was intended by the framers of the law.

Comparatives where net income of pre-war period is abnormally low.—A point of interest, where 1917 corporation returns are still under review, arises in a ruling given under the following circumstances: The appellant corporation contended that by reason of foreign competition in its particular product, which reached a high mark in the years 1911-1913, inclusive, its average profits for those years did not reflect its true earnings for the purposes of establishing a pre-war income. Relief was sought under section 205 of the 1917 law. In refusing to grant the relief the Committee stated:

RULING. . . . . This contention, however, was not peculiar to this appellant. It is admitted that the act of the foreign government affected approximately all American concerns engaged in the same business. It is admitted, therefore, that while this was an unusual year of depression, all like trades were affected to the same extent as that of the appellant. . . . . (B. 39-21-1849; A. R. R. 618.)

The crux of the situation lies in the fact that the peculiar conditions affected the particular trade as a whole. This very fact would rob the application of section 205, of the 1917 law, of its effectiveness. The relief to be provided by that section is the deduction of

[3] *Congressional Record,* February 11, 1919, page 3135.

(1) An amount equal to the same percentage of its invested capital for the taxable year which the average deduction . . . . for such year of representative corporations . . . . engaged in a like or similar trade or business is of their average invested capital for each year. . . .

In other words, no relief is offered by the law except where conditions of the one concern in a trade are contrary to those of other concerns in that same trade. The same principle is true in the application of section 328 (a) of the 1918 and 1921 laws.[4]

Can the Treasury's decisions in relief cases be reviewed by the courts?—The question has been asked: Can the courts review the action of the Treasury in relief cases? If taxpayers are not satisfied with the decisions of the Treasury, can they seek relief in the courts? Some lawyers are of the opinion that relief sections cannot be reviewed by the courts. They believe that final action lies entirely within the discretion of the Commissioner. Section 328 defines how the tax shall be computed: "the Commissioner shall compare the taxpayer only with representative corporations."[5] The law does not say that the taxpayer shall be compared with representative concerns selected by the Commissioner, although it is obvious that the Commissioner *must* select. The point is that the exercise of this particular task is ministerial and not discretionary.[6] Failure to select representative concerns as defined in the law would seem to permit an appeal to the courts.

Subdivision (b) of section 328 provides that:

LAW. Section 328. . . . . **(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.**

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[4] For procedure in the case of affiliated corporations, see page 327.

[5] Section 328 (a).

[6] For distinction between discretionary and ministerial powers, see 29 Cyc. 1433, 1442-4.

The foregoing does not say, however, that the Commissioner's action shall be final. Broad powers of this kind are not usually invested in an administrative officer without giving the right of appeal to the courts.

If the Commissioner were ordered to certify to a court the representative corporations which were used in a particular case, the court should have very little difficulty in deciding whether or not they meet the requirements of the statutory definition. And in cases where applications had been refused, a court should also have little difficulty in determining whether or not concerns meet the requirements of section 327.

Page 334

Method of payment of tax for 1921 when relief is expected.—When the profits taxes included rates up to 80 per cent, the relief sections provided that, pending consideration of claims, a maximum of 50 per cent could be paid. With the maximum rate of excess profits tax standing at 40 per cent, the privilege (?) of paying 50 per cent pending consideration is somewhat of a joke.

The author is still of the opinion that the procedure outlined in his 1921 edition of *Excess Profits Tax Procedure*, page 335, is valid.

Articles 912 and 913 were revised in 1921 to read as follows. The corresponding articles of Regulations 62 contain similar provisions.

DETERMINATION OF FIRST INSTALMENT IN CASE OF DOMESTIC CORPORATIONS.—

REGULATION. In the case of any corporation, other than a foreign corporation, where absolutely no data are available for the determination of invested capital for the taxable year, the installments of the tax shall in the first instance be determined upon the basis of a war profits and excess profits tax equal to 50 per cent of the net income, except that for 1919 and subsequent taxable years, in the case of any corporation other than a foreign corporation, such installments shall be determined upon the basis of an excess profits tax equal to 20 per cent of the net income in excess of $3,000, but not in excess of $20,000,

plus 40 per cent of the net income in excess of $20,000. In any other case under section 328 of the statute other than the case of a foreign corporation, but including a case where the invested capital for the taxable year can not be accurately determined, but where a minimum amount of invested capital, as to which there is no question, can be determined, the installments shall in the first instance be determined upon the basis of a war profits and excess profits tax computed by using the minimum invested capital, the tax in any such case not to exceed an amount equal to 50 per cent of the net income, and for 1919 and subsequent taxable years not to exceed 20 per cent of the net income in excess of $3,000, but not in excess of $20,000, plus 40 per cent of the net income in excess of $20,000. (Art. 912, amended by B. 42-21-1877; T. D. 3235.)

Determination of first instalment in case of foreign corporations.—

Regulation. In the case of a foreign corporation the installments of the tax shall in the first instance be determined upon the basis of a war profits and excess profits tax computed by using its invested capital for the taxable year 1917, such tax for any taxable year not to exceed an amount equal to 50 per cent of the net income, and for 1919 and subsequent taxable years not to exceed 20 per cent of the net income not in excess of $20,000, plus 40 per cent of the net income in excess of $20,000. For the purpose of this article the invested capital for 1917 shall be adjusted for any subsequent changes in its amount due to cash or property paid in or withdrawn or to surplus or undivided profits of prior years retained in the business and properly attributable to its business within the United States. If the tax for 1917 was determined under section 210 of the Revenue Act of 1917, the constructive capital which would result in a tax equivalent to the tax determined under that section shall be used. In the case of a foreign corporation which was organized subsequent to the taxable year 1917, or which had no income from sources within the United States during 1917, the installments of the tax shall in the first instance be determined upon the basis of a war profits and excess profits tax equal to 50 per cent of the net income, except that for 1919 and subsequent taxable years such installments shall be determined upon the basis of an excess profits tax equal to 20 per cent of the net income not in excess of $20,000, plus 40 per cent of the net income in excess of $20,000. (Art. 913, amended by B. 42-21-1877; T. D. 3235.)

Claims for credit against overpayments under section 328.—The following ruling indicates that the procedure suggested by the author will not be acceptable to the Treasury.

Ruling. Reference is made to your letter of March 8, 1921, relative to corporation returns to be filed for 1920 under the provisions of Sections 327 and 328 of the Revenue Act of 1918.

You state that it is your understanding that in filing returns for 1920 under the above-mentioned sections, claim for credit may be applied against the amount of the first installment of tax due thereon to the extent that it is estimated the amount of tax paid was in excess of the amount due as computed under the provisions of Section 328. You inquire as to a justifiable percentage of tax on income for 1919 to be used as the basis for a claim for credit against the first installment of the tax for 1920.

In reply your attention is invited to Section 328 (a) which provides in part that "In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business bears to their average net income (in excess of the specific exemption of $3,000) for such year." The special relief afforded by Sections 327 and 328 is based upon the merits of the individual case, and the provisions of section 328 do not permit the determination of a general average for any trade or business.

Claim for credit may not under any circumstances be applied against taxes due until the Bureau has definitely determined that the amount of the claim is actually in excess of the amount of taxes due on the previous return. Until complete audit comparatives are available for use in computing under Section 328 the taxes due on 1919 returns, the exact amount of tax due thereon can not be determined, and, consequently, claims for credit in the amounts believed to be in excess of tax due for the previous year may not be applied against the amount of the first installment of the 1920 taxes. (Letter to The Corporation Trust Company, signed by Commissioner Wm. M. Williams, and dated March 23, 1921.)

If it is obvious that the application of the relief sections will disclose an overpayment, no harm can be done by permitting the estimated overpayments to be credited against any taxes which may be due. Subsequent adjustments, if any, in favor of the government would bear interest at the rate of 6 per cent per annum from the time when they were originally due. This is a privilege which could be abused, but until there is evidence of abuse, credits should be allowed. Recent cases have come to light in which the assessment of excessive taxes has thrown corporations into bankruptcy. In all cases,

such as the foregoing, in which the Commissioner has discretion to permit claims for credit, every effort should be made to extend aid to all taxpayers who deserve it.

Page 343

Relief will not be granted when expenditures for intangibles can be restored.—The Treasury has reconsidered its position regarding the restoration of expenditures for intangible assets previously charged to expenses.[7] The logical result of its original position was that corporations which had a large investment in intangible assets (paid for in cash) and a negligible investment in tangible assets at January 1, 1917, were forced to seek relief. An embarrassment arose when it was found that representative concerns were similarly situated, so that little if any relief could be granted. The decision of the United States Supreme Court in the *La Belle Iron Works* case clearly indicates that the entire actual investment in capital assets at January 1, 1917, must be included in invested capital. This throws upon taxpayers the burden of supporting claims for restoration of capital items charged off. In many cases the task is feasible because it is merely a problem of the analysis of accounts.

In A. R. M. 141, Bulletin 47-21-1937, the Committee on Appeals and Review takes the position that when expenditures can be restored other relief is not necessary.

Page 353

Relief not granted merely because corporation earned a high rate of profit.—Relief is usually denied in cases in which the capital employed has been ample for the needs of the business and in which abnormal profits in the war years resulted from the high prices and profits which prevailed in those years. Even where contracts made in 1916 resulted in large profits in 1917, relief was denied.[8]

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[7] See page 1644 for full discussion.
[8] C. B. 4, page 401; A. R. R. 518.

Much seems to depend upon the trend of representative concerns. If most concerns in an industry were prosperous and paid higher taxes during the war years, there will be difficulty in securing relief; but if many concerns in an industry paid relatively low rates of tax, a concern in that industry which claims to be affected by abnormal conditions has a fair chance of securing relief. The following is an illustration of the latter class.

Ruling. . . . . The Committee is, however, of the opinion that due to conservative capitalization, the realization of net income in 1918 resulting from the investment of capital which was nonincome producing during the prewar period and for a number of years subsequent thereto, and the payment of salaries to officers which were extremely low as compared to salaries paid by other concerns engaged in the same line of business of similar volume (one salary only being paid to an officer of the company for 1918), abnormal conditions existed during 1918 and that the assessment of excess profits and war profits taxes for that year under section 301 of the Revenue Act of 1918 will work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax so computed and the tax assessed against representative corporations. . . . . (B. 28-21-1730; A. R. R. 538.)

Taxpayers seeking relief should read the decision of the United States Supreme Court in the *La Belle Iron Works* case.[9] In many cases it is possible to show an investment at January 1, 1917, in excess of the invested capital as shown by the books. Before seeking relief, attention should be given to restoring any expenditures charged off in prior years the benefits of which extend into 1917 and subsequent years. The court held that invested capital must not include appreciation, but that the entire cost of the investment at January 1, 1917, could be included.

In one case a taxpayer claimed relief on the ground that goodwill was worth more than the capital stock issued for it, and that, in addition, machinery in use in 1917 had been charged off in 1907. The decision[10] refers to the right of

[9] 41 Sup. Ct. 528 (published as T. D. 3181).
[10] B. 37-21-1823; A. R. R. 599.

taxpayers to restore property charged off prior to 1917, and states that, since the goodwill was not purchased, no good reason for relief was shown.

Page 356

Computation of tax of foreign corporations.—Under both the 1918 and 1921 laws, foreign corporations must be taxed under section 328.

The author knows of several instances in which foreign corporations are engaged in business solely in this country and are, of course, able to determine their invested capital. Such corporations should not be taxed in excess of what they would pay if the tax were measured by invested capital. In making application for relief the facts should be shown.

CHAPTER XVI

ADJUSTMENT OF NET INCOME FOR TAXABLE AND PRE-WAR YEARS

Page 362

Interest received.—The changes made by the 1921 law in the exemption of income from Liberty bonds are fully covered in Chapter XX; reference thereto should be made to determine the amount of Liberty bond interest which is subject to the excess profits tax in 1921.

Page 363

Dividends.—The changes in the taxability of dividends are fully discussed in Chapter XXII.

Depreciation.—Where the Treasury has reduced, for 1917 and subsequent years, the depreciation rates applied by the taxpayer, an adjustment of all returns should be made in

order to secure the advantage of the higher pre-war income thereby obtained, as well as to increase the invested capital for 1917 and subsequent years.

Adjustment of Net Income for Pre-war Period

The foregoing comments on interest, dividends, salaries and depreciation should be noted.

Sale of assets prior to 1913.—If income was derived from the sale of capital assets in 1911, or 1912, and if the gain thereon was based on cost prior to January 1, 1909, it has been decided[2] that such property may be valued as at January 1, 1909, and the gain, in the event that such value exceeds the original cost, measured by such determined value.

Page 364

Salaries.—Where the salaries paid to officers of close corporations have been reduced by the Treasury for the years 1917 or 1918 to an amount less than those paid in the pre-war years, consideration should be given to the possibility that the salaries paid in pre-war years may have been, in part, distributions of profits. An adjustment in such cases can be made, thereby increasing the average pre-war income.

A full discussion of the reduction of salaries by the Treasury is given in Chapter XXVI.[1]

CHAPTER XVII

REORGANIZATIONS

Page 382

The 1921 law makes no changes in those excess profits tax provisions of the 1918 law which deal with reorganizations.

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[1] See also B. 39-21-1841; A. R. M. 138.

[2] *G. N. Ry. Co. v. Lynch*, U. S. D. C., Minn. No. 797, issued as T. D. 3147 (C. B. 4, page 277).

The changes which vitally affect taxable profits under the income tax provisions of the law are dealt with in Chapters XVI and XVII. A new section[1] is added which permits partnerships, under certain conditions, to incorporate and to be taxed as corporations as from January 1, 1921, even though incorporated as late as March 23, 1922.

Very few rulings have been published on this subject since the issue of *Excess Profits Tax Procedure,* 1921.

Page 383

Determination of new corporate entity.—

RULING. Where under the laws of a State a charter granted to a corporation is limited to a period of years, the renewal of such charter merely prolongs the existence of the original corporation and does not of itself constitute a reorganization within the meaning of the excess profits tax laws. (B. 21-21-1657; O. D. 930.)

The foregoing office decision merely affirms existing practice.

Page 390

Invested capital of corporations reorganized before or after March 3, 1917.—Practically all of the rulings in 1921 deal with reorganizations made after March 3, 1917.

REORGANIZATIONS PRIOR TO MARCH 3, 1917.—The following recommendation of the Committee emphasizes the point that property taken over in reorganizations prior to March 3, 1917, must be valued as at the date of transfer, and also provides that an appraisal may be used to establish such value.

RULING. Held, that the appraised value of the plant of a corporation based on cost as of December 22, 1919, plus depreciation from February 14, 1917, the date the property was taken over to that date, be used to determine the value at February 14, 1917; that depreciation rates be determined by the life of the property and applied to value determined at acquisition, with an accelerated rate on machinery during 1917 when the plant was running at double capacity. . . . (C. B. 4, page 371; A. R. R. 390.)

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[1] Section 229. See page 1657.

The foregoing ruling may be sound. The law was intended to give effect to valuations prior to March 3, 1917, when reorganizations had been made without notice of an invested capital law. The law does not state that reorganizations, the inadvertent effect of which reduces invested capital, should be penalized by having the invested capital of the new entity reduced below that of the old one.

The court decisions handed down during 1921 shed no light on the effect of reorganizations made prior to March 3, 1917. In the *Phellis* case,[2] the Supreme Court said, "We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the sixteenth amendment and income tax laws enacted thereunder." In the *La Belle Iron Works* case,[3] the court repeatedly said that the actual investment of taxpayers must be allowed as invested capital.

It is therefore reasonable to assume that when called upon, the Supreme Court will decide that in case of reorganizations made before March 3, 1917, when the "new" interests are substantially the same as the old, a mere change in corporate identity will not result in a reduction of the invested capital of the new entity.

Page 395

Reorganizations after March 3, 1917.—It is often difficult to decide whether or not the old owners retain 50 per cent or more of the control of a reorganized corporation. This is purely a question of fact. Therefore, each case must be carefully considered. Published rulings, for this reason, are not very helpful.

Ruling. A corporation upon organization after March 3, 1917, issued its entire capital common stock for the net assets of a partnership as a going concern and x dollars in cash. The principal officers of the corporation were the partners. A few shares less than a ma-

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[2] *U. S. v. C. W. Phellis,* U. S. Supreme Court, November 21, 1921.
[3] 41 Sup. Ct. 528.

jority were authorized by the officers of the corporation to be recorded by the transfer agent in the names of the former partners, the remaining shares being issued to their nominees and becoming well distributed to the public. The corporate books were in the hands of one of the former partners, and from this record he had intimate knowledge of stock held by outside interests.

Held, that the partners remained in control of the business and exercised this control in naming their nominees, and that an item of x dollars or any part thereof, representing "good will, trade-marks, and foreign agencies" transferred to the corporation, should be disallowed as invested capital of the corporation in accordance with section 208 of the Revenue Act of 1917, the amounts expended by the partnership for such assets being charged to cost of conducting the business. (C. B. 4, page 405; A. R. R. 409.)

The facts of the foregoing ruling are given in the detailed opinion as follows:

The M Corporation was incorporated April, 1917, with a capital stock of 100y shares, taking over the net assets of the N partnership as a going concern as of January 1, 1917, and in addition thereto the sum of x dollars in cash. The consideration for the net assets of the partnership and the additional cash was the sum of 4x dollars to be paid by the corporation issuing to the partners, or to their nominees, the entire issue of capital common stock of the corporation consisting of 100y shares. Certain adjustments were made of salaries of the partners to offset the credit for earnings from January 1, 1917, to April, 1917. . . . .

Of the 100y shares of stock issued by the corporation, the following shares were authorized by the officers of the corporation to be recorded by the transfer agent in the names of the former partners:

B	18y shares
C	10y shares
A	21y shares
Total	49y shares

or a few shares less than 50 per cent of the total issue of stock to them. According to the records of the transfer agent, the remaining shares were issued to the stockholders in number from 1 to 25y shares. The stock issued to the public was very well distributed. In the corporate organization B became president and general manager, C vice president and secretary, and A chairman of the board of directors and treasurer of the corporation.

The Committee supported its opinion as follows:

. . . . It would appear, therefore, that the sole question at issue rests upon the intent of the words "remains in control" as used in the Act. It is clear from the above facts that the partners who became the principal officers of the corporation continued in position to exercise direct and effective control over the affairs of the business. The corporate books were in the hands of one of the former partners and from this record he had intimate knowledge of the ownership of stock held by outside interests.

Apart from this effective control it is clear that by agreement and bill of sale the partners received the entire capital stock of the corporation for the net partnership assets and for other valuable considerations. This gave the partners immediate authority to dispose of such stock in any manner they might desire. Technically, the proceeds from the sale of any or all of the stock passed to the partnership. Out of these proceeds the partners paid to the corporation such amount or amounts as the partners had agreed to pay in part consideration for the stock received by them. In other words, the transaction was between the corporation and the partners and the latter named the proportion in which they desired the stock distributed to them and to their nominees. Hence, the partners did remain in control. They exercised this control in naming their nominees. It is immaterial that this stock control was not continuing—that it immediately passed by a small fraction into other hands.

Without a complete knowledge of all the facts, it is difficult to comment upon cases of this kind, but it appears that the Committee has permitted a technicality to defeat the intention of the law.

In all cases in which new interests invest capital at the increased valuations, such capital is entitled to be fully recognized. If a technicality is applied it should be applied against the government, not against taxpayers. New interests might pay old interests $100,000 for assets carried at $10,000 and receive 99 per cent of the capital of a new corporation. The old stockholders would be heavily taxed on a closed transaction. If the old interests were retained to exercise complete control over the new corporation, under the ruling the invested capital of the new corporation would be $10,000!

The foregoing case may be compared with a more recent one. The Solicitor, at the request of the Committee, prepared an opinion on the following case. The quotations are from his opinion, which was accepted by the Committee.

RULING. In December, 1917, A was the owner of a certain business, which he engaged in under the name of X. In that month his son, B, together with two other persons, formed a corporation known as the M Company for the purpose of acquiring the assets of the business conducted by A so that the business might be continued by the corporation. On December —, 1917, A offered to sell to the corporation all his right, title, and interest, in and to the assets of the business that had been conducted by him, in consideration of the issuance of $48\frac{3}{4}$ y shares of stock of the corporation to seven persons, who were named in the offer. A was to receive $\frac{1}{2}y$ shares, his children and close connections were to receive the remainder. The corporation was authorized to issue not more than $50y$ shares of stock under its charter. The offer was accepted by the corporation. The assets were then transferred to the corporation and the stock was issued to the designated persons in accordance with the agreement, with the exception of two qualifying shares issued to other persons. After the consummation of this transaction A held $1\frac{1}{2}y$ shares of the corporate stock, y shares being purchased by him for cash.

Two questions are raised (1) whether the transaction in question constituted a reorganization of the business or a sale of the business to the corporation, and (2) whether an interest or control of 50 per cent or more of the business remained in A, the owner of the business prior to its transfer to the corporation. . . .

As A chose to specify in his offer the persons who were to receive the stock, which, on acceptance by the corporation, obligated it to issue the shares to the persons designated (which obligation was promptly carried out), it is clear that the limitations of the statute do not apply, notwithstanding the relationship existing between A and the persons whom he designated to receive the stock, provided the transaction was bona fide and not designed to conceal the real ownership of the stock.

It appears from the evidence that the transaction was bona fide. An explanation of the transaction lies in the fact that A desired to provide for his children during his own life time and retire from active business. Almost immediately after he transferred the assets of his individual business to the corporation he retired from business and died about two months later. There seems to be no doubt that the issuance of the stock to the persons designated in the offer was absolute and unconditional and that A made no attempt to retain any interest, either directly or indirectly, in the stock.

For these reasons it is the opinion of this office that A did not retain an interest or control of 50 per cent or more in the trade or business previously owned and engaged in by him under the name of X and that, therefore, the case does not come within the provisions of section 208 of the Revenue Act of 1917 and section 331 of the Revenue Act of 1918.

It is immaterial in determining the question of invested capital whether the transaction in question constituted a sale or reorganization, and no opinion in connection therewith is expressed. (B. 43-21-1890; A. R. R. 645.)

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Article 941[4] of the new regulations continues the same article of Regulations 45, which had been amended on December 7, 1921, to read as follows:

REGULATION. Where a business is reorganized, consolidated or transferred, or property is transferred, after March 3, 1917, and an interest or control of 50 per cent or greater in such business or property remains in the same persons or any of them, then for the purpose of determining invested capital each asset so transferred is valued (a) at an amount representing its actual cash value, subject to the limitations imposed by section 326, but not exceeding its allowable value, for invested capital purposes, in the possession of the previous owner, if a corporation, or, if not a corporation, (b) at its cost to such previous owner, with proper adjustments for losses and improvements. . . . . (Art. 941.)

The foregoing amendment was made pursuant to an opinion of the Solicitor of Internal Revenue which read as follows:

RULING. . . . . The validity of article 941, in so far as it provides that section 331 applies only when an interest or control of 50 per cent or more remains "in any of the previous owners," has been questioned.

The following hypothetical case, which is merely illustrative of actual cases which have arisen, has been presented. The N corporation transfers to O corporation, subsequent to March 3, 1917, tangible property in exchange for 20 per cent of its stock. Seventy-five per cent of the stock of corporations N and O is owned by the same individual but the corporations are not affiliated.

It is apparent in this case that an interest or control of 50 per cent or more in the property does not remain after the exchange "in any of the previous owners," inasmuch as the N corporation, the previous owner of the asset, owns only a small proportion of the outstanding stock of the O corporation. Thus, if article 941 correctly interprets this section of the statute, the O corporation can include in invested capital the actual value of the property exchanged, subject to the limitations contained in section 326, even if such value is in excess of the allowable value for invested capital purposes of the property to the N corporation.

Section 331, however, limits the amounts to be included in the invested capital of the new owner if an interest or control in the property of 50 per cent or more "remains in the same persons or any of them." In the case stated above it is apparent that, by virtue of

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[4] Art. 941 as it originally read appears in *Excess Profits Tax Procedure*, 1921, page 397.

stock holdings, a control in excess of 50 per cent in the property transferred "remains in the same persons," i. e., the stockholders of the N and O corporations.

Article 941 of Regulations 45, therefore, is incorrect, in so far as it provides that in order that section 331 be applicable an interest or control of 50 per cent or more in the property exchanged must remain in the previous owners.

Article 941 provides further that where section 331 applies the property transferred, if transferred by a corporation, is valued, for the purpose of determining invested capital, as if still in the possession of the previous owner.

The provisions of article 941 on this point can be most clearly shown by application to a specific case: The N corporation, which owned 50 per cent of the outstanding stock of the O corporation, transferred subsequent to March 3, 1917, unimproved real estate, which cost it $100,000 but which at the time of the exchange, due to a decrease in market value, was worth only $20,000, to the O corporation in exchange for stock. Under the provisions of article 941 the asset so transferred should be valued, for the purpose of determining the invested capital of the O corporation, "as if still in the possession of the previous owner." That is, the O corporation should include in invested capital, on account of the asset transferred, $100,000, the allowable value of the asset, provided for invested capital purposes, to the N corporation, in spite of the fact that the actual cash value of the asset at the time of the exchange was only $20,000.

Section 326 provides that invested capital includes "the actual cash value of tangible property other than cash, bona fide paid in for stock or shares, *at the time of such payment* . . . ." Section 331 makes an exception to this general rule in the case of a change of ownership of property between corporations subsequent to March 3, 1917, where an interest or control of 50 per cent or more remains in the same persons, and provides that in such case the property transferred shall not be allowed a greater value, for invested capital purposes, "than would have been allowed . . . . in computing the invested capital of such previous owners . . . . ." In the case stated above, the asset paid into the O corporation for stock should be included at its actual cash value at the time paid in, under the provisions of section 326 unless the case falls within the exception covered by section 331. This latter section merely provides, however, that an asset so transferred shall not be allowed a greater value than would have been allowed the previous owner, if a corporation, and is, therefore, by its own terms, inoperative unless the actual cash value of the property at the time of the exchange is in excess of the allowable value of the property, for invested capital purposes, in the hands of the previous owner. Inasmuch as the actual cash value of the asset transferred, in the instant case, was $20,000, a lesser amount than the allowable

value of the asset, for invested capital purposes, in the hands of the N corporation, section 331 is not operative. Therefore the O corporation should include in invested capital, under section 326, $20,000, the actual cash value of the asset at the time paid in for stock.

It is concluded that:

(1) Section 331 of the Revenue Act of 1918 is not made inapplicable because of the fact that a control of 50 per cent or more, in the trade, business, or property reorganized, consolidated, or exchanged, subsequent to March 3, 1917, does not remain in any of the previous owners, provided such control does remain in the same persons, or any of them.

(2) Where section 331 applies to the transfer of assets from one corporation to another, the assets transferred shall be valued, for invested capital purposes, in accordance with the provisions of section 326, provided such value does not exceed the allowable value, for invested capital purposes, of the assets, if such assets had not been transferred. . . . . (I-3-39; L. O. 1081.)

Whatever may be said for the foregoing opinion as an attempt to construe the letter of the law, it certainly does not express the intent which has been evident from the inception of the section in question. The intent of the law is clearly to prevent the increasing of invested capital by a reorganization or apparent sale of property when in fact there has not been a decided change of ownership or control, i.e., at least 50 per cent. To prevent such increase in invested capital, the 1917, 1918 and 1921 laws have each provided that after March 3, 1917 (the date of the first excess profits tax law), unless a reorganization, consolidation or change of ownership of a trade or business (and under the 1918 and 1921 laws, also in cases of change of ownership of property) resulted in at least a 50 per cent change of interest or control, the assets acquired by the new corporate entity should not be allowed a greater value for invested capital purposes than if there had been no such transfer of title.

The phrase "greater value" which it is stated shall not be allowed is restrictive and its apparent intent is to require the computation of the new corporation's invested capital to be made on the same basis as though the predecessor corporation were still the owner of the business or property. This is

further supported by the latter part of section 331 of the 1918 and 1921 laws, which provides for the computation of invested capital for the new corporation, when its business or property was acquired from an individual, individuals or partnership which continue to have 50 per cent or more interest in or control of the new corporation. The computation of invested capital in such case is to be based, not on value of the assets at date of acquisition by the corporation, but on their cost to the previous owners.

There is no reason to think that Congress intended the invested capital of a corporation organized after March 3, 1917, to be computed on one basis if the preceding holder of title to the property was a corporation, and on an entirely different basis if the preceding holder of title was one or more individuals or was a partnership. In both cases the present corporate owner and the preceding corporate, individual or partnership owner represented to the extent of at least 50 per cent the same interests.

The only reason for distinguishing in section 331 of the 1918 and 1921 laws cases of preceding ownership by corporations from those of preceding ownership by individuals or partnerships, is that only corporations had invested capital for excess profits tax purposes. Under the 1917 law, which imposed an excess profits tax on corporations, partnerships, and individuals, no such distinction was necessary, nor was it made in section 208 which corresponds to section 331 of the 1918 and 1921 laws.

Valuation of assets of domestic corporation acquired from a foreign one.—

Ruling. The M Company was incorporated for the purpose of acquiring that part of the business of the N Company, a foreign corporation, which it carried on in the United States and Canada.

The M Company issued common and preferred stock to the N Company, in the amount of x dollars, in exchange for its business in the United States and Canada. The domestic corporation requested permission to set up on its books as invested capital several increases

over the amounts carried on its books for the same items by the foreign corporation.

Held, that where a foreign corporation has been taxed on its activities in this country, and its activities in Canada and this country are subsequently taken over by a domestic corporation organized for that purpose, and fifty per centum or more of the stock of the domestic corporation is held by the foreign corporation, the assets of the domestic corporation are to be valued under section 331, Revenue Act of 1918. In the case presented the domestic corporation may set up on its books as invested capital the assets taken over from the foreign corporation at such values as could have been established had the previous owner been required to set up invested capital as a domestic corporation. (C. B. 4, page 405; O. D. 789.)

Incorporation of an individual or a partnership before March 23, 1922.—The 1921 law re-enacts that part of section 330 of the 1918 law which permitted partnerships or individuals to incorporate before July 1, 1919,[5] but under the new law (section 229) the incorporation must take place not later than March 23, 1922.

Law. Section 229. **That in the case of the organization as a corporation within four months after the passage of this Act of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade**

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[5] **[Former Procedure]** The Committee has held that the provisions of the 1918 law do not apply to 1917.

Ruling. Held, that a corporation, organized in October, 1917, which acquires the business and properties of a partnership as of January 1, 1917, the ownership continuing identical as does the business, can not make a return for the entire year, as if it were a corporation, using the invested capital of the partnership as of January 1, 1917, as its invested capital. (B. Digest 16-21-1586; A. R. R. 467.)

or business: *Provided,* That this section shall not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year: *Provided further,* That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.

In order to qualify: (1) capital must have been a material income-producing factor; (2) the net income for the taxable year must have been at least 20 per cent of the invested capital for the taxable year; and (3) the taxpayer must pay a capital stock tax for the year 1921 in the same manner as if the taxpayer had been a corporation.

CHAPTER XVIII

INCOME FROM GOVERNMENT CONTRACTS

The tax on income from government contracts made between April 6, 1917, and November 11, 1918, is continued to include the year 1921. With the conclusion of 1921, this provision automatically expires with Title III of the law (war profits and excess profits tax for 1921), of which it forms a part. The basis of computation is identical with that called for by the 1918 law.

Supplementary contracts.—The Treasury has ruled as follows:[1]

RULING. Income arising from a contract entered into subsequent to November 11, 1918, which is supplementary to an original contract entered into with the Government between April 6, 1917, and November 11, 1918, is taxable under Section 301 (c) of the Revenue Act of 1918. (B. 42-21-1867; O. D. 1063.)

The imposition of the higher rate of taxation on revenue from government contracts was primarily intended to tax

[1] See also I-2-16; Sol. Op. 128.

the abnormal profits which might possibly accrue under war conditions.

The extension of the provision to include continuation contracts is an unwarranted imposition in principle, and it is opposed to the spirit of the law under which this form of contract was first taxed.

Nevertheless the ruling is sound. Contractors could not legally be compelled to execute supplementary contracts. When they did so they were on notice that any contract which was merely supplementary to one executed before November 11, 1918, would be construed as if it were part of the original contract.

CHAPTER XIX

NOMINAL CAPITAL—THE 1917 LAW FORMER PROCEDURE

The meaning of the words, "no invested capital or not more than a nominal capital," in section 209 of the 1917 law, have been construed so strictly by the Treasury that few concerns have been able to qualify as having "not more than a nominal capital." The Treasury, in many such cases, has denied the claims of corporations to be assessed under section 209, and has assessed the tax under section 210 (the "relief" section).

As a part of its effort to vitiate the obvious intent of the 1917 law, the Treasury has attempted to enforce, for the year 1917, two restrictions[1] found in the 1918 law (section 200) regarding personal service corporations, viz.: (1) the corporation must be engaged principally in rendering personal service; and (2) the earnings must be ascribed primarily to

[1] Reg. 41, Art. 71.

[Former Procedure]

the activities of the owners. That such a construction of section 209 is not warranted, is indicated in the following:

DECISION. In determining the question whether such a corporation, deriving its income solely from royalties or licenses from patents, can be said to be a corporation "having no invested capital or not more than a nominal capital," within the meaning of section 209, reference is made in behalf of the collector to the Congressional Record of October 6, 1917, containing a statement by Hon. Claude Kitchin, who was at that time chairman of the Ways and Means Committee. It appears from this statement that the Excess Profits Tax Law, as contained in the House Bill, applied only to corporations and partnerships, and not to individuals. The Senate brought within the scope of the law individuals in trade or business, but excluded lawyers, doctors, professional men, and officers of corporations, as well as governmental officers. The House conferees, it would seem from Mr. Kitchin's statement, opposed the inclusion of individuals, unless they were all brought in. The Senate insisted upon the exemptions, and section 209 of the act resulted, which, it is the claim of the collector, was intended to apply to a definite class of persons; i.e., lawyers, doctors, professional men, and high-salaried officers of corporations and the government.

If this idea of providing especially for those rendering a personal service was all that was in the minds of the conferees, there seems to be no reason why they should not have used more exact language to convey their meaning, and further there is no reason at all why Congress should have specifically provided that, in a case of a trade or business "having no invested capital or not more than a nominal capital," there should be assessed a tax other than the tax to which such trade or business would otherwise be liable under section 201, unless there was to be a distinction between those employing "invested capital" and those employing "nominal capital." These terms admit of exact definitions.[2]

The court then disposes of the contention that by "nominal capital" what is really meant is "nominal (invested) capital" as follows:

DECISION. The determination of this case must, as already indicated, depend upon the meaning of the words "not more than a nominal capital." It is clear from section 207 that the patents from which the plaintiff derived its revenue cannot be regarded as "invested

[2] *DeLaski & Thropp Circular Woven Tire Co. v. Iredell, Collector,* 268 Fed. 377.

[Former Procedure]

capital." Counsel for the plaintiff, in a most exhaustive and painstaking brief, has shown that the treasury rulings indicate that the word "invested" was omitted in the act by oversight in the phrase "not more than a nominal (invested)capital." This suggestion, however, is not well taken, for the reason that, whatever the treasury rulings may have been, they can be given no force to modify or add to the clearly expressed language of Congress.[3]

The real test in all these cases is found in an answer to the question: What enabled the corporation to earn its income? If the capital is in fact "nominal," as determined by the sources of its net income, so that it cannot be said that capital was a material factor, such capital must be "nominal." The application of this test is admirably stated by the court, as follows:

Decision. The decision of this case, however, need not depend solely upon the meaning of the word "capital," to be found in the distinction between "invested capital" and "nominal capital," as used in the act. The patents which the plaintiff owned were the concrete embodiment of the skill which the plaintiff possessed in its field of activity. This skill or service is bartered for a consideration. Such skill or service is like the service a lawyer in a large practice renders for an annual retainer, and is very nearly akin to the service which a commission house renders to those who buy and sell through it, or the service of a concern engaged in selling or leasing real estate, and in writing insurance. The plaintiff's source of income was that which certain persons were willing to pay it for the use of its skill and knowledge. It is true that skill and knowledge had been reduced to concrete form; but the payment was for the use of the skill and knowledge, and not for any part or parcel of the form to which the skill and knowledge had been reduced. Hence it would seem that in a very real sense the plaintiff was engaged in rendering a personal service, and was not employing "capital," and certainly no more than a "nominal capital."[4]

In another case[5] the court assumed that " 'nominal capital' in Section 209 means 'nominal invested capital' without, of course, passing upon that question."

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[3] *DeLaski & Thropp Circular Woven Tire Co. v. Iredell, Collector,* 268 Fed. 377.

[4] *Ibid.*

[5] *Lincoln Chemical Company v. William H. Edwards, Collector,* 272 Fed. 142.

[Former Procedure]

The question is important because the decisions of the courts as to the kinds of corporations entitled to be classed as those having "not more than a nominal capital under the 1917 law," will strongly influence the determination as to whether or not similar corporations can secure personal service classification under the 1918 law.

Corporations should be taxed under section 209 at the 8 per cent rate when there is a gross disproportion between the amount of gross business and the actual capital of the corporation. This does not include corporations which had small, but ample, capital; there must be taken into consideration the character of the business and the manner in which it is conducted. If capital is not material as compared with the income earned, such a corporation is entitled to the 8 per cent rate, if the trend of court decisions is to be relied upon.

In the case of a partnership, classification under section 209 was denied for the following reasons:

> RULING. . . . . Because of the volume of business transacted by the partnership during the year 1917 through direct buying and selling of merchandise, and the numerous accounts receivable and payable shown on the firm's balance sheets, both at the beginning and close of the taxable year, the Unit denied assessment under section 209, ... (C. B. 4, page 16; A. R. R. 364.)

Where a substantial part of the income received was deemed to be from the company's superintendents and salesmen, assessment under section 209 was denied.[6]

In both of the foregoing cases assessment was made under section 210 (the "relief" section).

In a case in which the actual work was done by laborers, but was supervised by principals of the corporation who were able to secure the contract for the work because of their experience and ability, it was held that the earnings were not derived from capital.[7]

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[6] C. B. 4, page 17; A. R. R. 464.
[7] B. 41-21-1858; A. R. R. 463.

[Former Procedure]

In the following case (metal brokerage business) although the broker might be sued on his contracts, entered into on behalf of his principal, the Treasury looked through the form and decided that the business had "not more than a nominal capital."

RULING. In the instant case it is clearly apparent that only nominal capital was employed in the business. No advances were made to the manufacturer, and collections from the purchaser only passed through the hands of the brokers. The goods were shipped direct to the purchaser, and therefore the officers of the corporation required no offices and no clerical assistance. It was merely a matter of securing orders for the product and placing these orders with the manufacturer. It was admitted in conference that under the contracts with the purchaser the M Company might be sued, but in view of the recognition by the purchaser that the M Company was merely acting in a brokerage capacity, without capital to insure recovery under any breach of contract, the real responsibility rested in the manufacturer, and that in event there should be any right of action it would rest against the purchaser. In view of this, the representatives of the taxpayer contend that for the purpose of arriving at a proper tax the Department should look beyond corporate form if it is considered the corporation was trading as a principal.

The Committee recognizes that it is only on the theory that the M Company might be held responsible under its contracts that assessment under section 209 can be denied. It considers, however, that the nominal capital of the corporation clearly established the fact that it was not contemplated it should be held responsible except by way of personal service to both the buyer and seller, and accordingly the corporation clearly comes within the contemplation of the section of the Act itself which provides that a corporation doing business on a nominal capital, or without any capital, should be assessed for excess profits tax at the rate of 8 per cent on its net income. (C. B. 4, page 20; A. R. R. 500.)

It cannot be said that during the year 1921 the question, "What is nominal capital?" has been solved until all phases of the question are passed upon by the United States Supreme Court. Corporations should protect their legal rights by filing claims for refund within the statutory time.

The following decision reversing the district court in the

case of which the syllabus was given in *Excess Profits Tax Procedure* 1921, makes it clear that a business conducted entirely with borrowed capital may qualify under the 1917 law as a "nominal capital" corporation. The important points in the decision are:

1. A corporation has no "invested capital" if the capital it employs does not come within the definition of invested capital as stated in the law.
2. Partners, debit balances (drawings) are not to be considered as accounts receivable of the partnership, representing "profits" left in the business, or as accounts receivable which might be used as a basis of credit.
3. Collateral deposited by a partner (being his individual property) as security for repayment of a loan to the partnership by a bank does not constitute "tangible property paid in" to the partnership and is therefore not invested capital.

DECISION.[8] The only question presented by this record is whether or not the partnership of Cartier-Holland Lumber Company during the year 1917 had an invested capital within the meaning of Section 201, 207 and 210 of Title II of the Act of Congress approved October 3, 1917.

If this question were to be determined separate and apart from the act levying this excess profit tax, then it would be of easy solution. Money invested in a partnership business, whether paid in by the partners or borrowed from a partner or a bank, in the absence of legislation to the contrary, would constitute invested capital in the ordinary meaning and acceptation of that term. Congress, however, evidently for the purpose of protecting the government from claims of inflated capitalization, thought it wise and necessary to define the term "invested capital," which is made the basis of the computation of the tax to be levied under the authority conferred by this Act. To that end Section 207 provided among other things the following:

> "As used in this title 'invested capital' does not include stocks, bonds (other than obligations of the United States), or

[8] *Charles E. Cartier and Edward M. Holland v. Doyle, Collector,* U. S. Circuit Court of Appeals, Sixth Circuit (December 15, 1921).

other assets, the income from which is not subject to the tax imposed by this title nor money or other property borrowed, and means, subject to the above limitations:

"(a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: . . . . ."

In the construction of the Act of Congress of which this definition is a part, this legislative definition of the term "invested capital" must be accepted as final and conclusive, regardless of any preconceived notion the public generally, or this court, may have as to the meaning of that term.

In the construction of this statute it must also be remembered that it is the settled rule not to extend the provisions of taxing statutes by implication, or to enlarge their operation, so as to embrace matters not specifically covered thereby. *Gould v. Gould,* 245 U. S. 141.

The trial court based its judgment for the defendant upon the conclusion of law that the collateral deposited by Cartier as security for his liability as an indorser of the partnership notes became a part of the working capital and was used and employed in the business of the company to the same extent as if it had been paid directly into the partnership funds.

This conclusion of law is not supported by the facts found by the court or by any evidence in this record. The articles of co-partnership provide that the paid-in capital of the partnership is to be $30,000.00, any or all portions of which amount is to be furnished to the partnership, upon notes signed by it, and to be paid at the earliest practicable opportunity out of the net earnings of the partnership.

It would seem unnecessary to say that a private contract between these parties would not change or affect, in the slightest degree, the plain and positive terms of the statute, declaring what shall be included and what shall not be included as "invested capital," for the purpose of this tax. If the articles of co-partnership had provided that the paid-in capital of the partnership should be $30,000.00, one-third of which should be paid in cash or in property by the partners, and

[**Former Procedure**]

$20,000.00 to be borrowed from a bank upon the notes of the partnership, indorsed by the partners, and further secured by the deposit of such collateral as the bank might demand, the money borrowed in pursuance of such partnership agreement, fixing the total capital of the partnership at $30,000.00, would necessarily be rejected as invested capital in the computation of surplus income taxes levied under this act. It logically follows that, if under this statutory definition of invested capital, money borrowed could not be included as capital where some substantial amount of cash had actually been paid into the partnership fund by the partners, such borrowed money can not be reckoned as invested capital where the partners contributed neither cash nor property to the partnership capital.

The original plan of operation written in the partnership agreement was abandoned as early as 1914, and thereafter the money used in the partnership business was borrowed directly from the bank upon the notes of the partnership, payable unconditionally and at certain fixed times, regardless of net earnings or any other contingency. While these notes were indorsed by the individual partners, nevertheless the money was borrowed by the partnership for partnership purposes, and it was primarily liable for the payment of these notes. Collateral held by the bank, a stranger to the partnership, whether the property of one or of both partners, was a mere incident to the loan, and can in no wise affect the character of the transaction.

It is therefore wholly unnecessary to determine whether under the original agreement the money to be furnished by Cartier, to be repaid out of the partnership earnings, would or would not be borrowed money within the meaning of this act. Nor is it important at whose suggestion this plan of operation was changed and the new plan adopted. It is sufficient for the purposes of this opinion to determine the legal effect of these transactions as they occurred during the taxing period of 1917. The evidence in relation to these transactions permits of no conclusion other than that the money borrowed from the bank upon the notes of the partnership was "borrowed money," within the meaning of Section 207 of the Act of Congress approved October 3, 1917.

The clear, positive and unambiguous language of Section 207 of this act is not subject to any other construction, regardless of the exigencies of any particular case. First it provides that borrowed money or other property shall not be included in the term "invested capital" as used in that title. Paragraph "A" of that section then specifically states what shall be included in determining the "invested capital" of a corporation or partnership as follows: "(1) Actual cash paid in." There is no claim made by the government that there was

[Former Procedure]

any "actual cash paid in" to the partnership funds other than the money borrowed from the bank on the notes of the partnership, endorsed by the partners, the endorsement of Cartier being secured by collateral deposited by him. "(2) The actual cash value of tangible property paid in other than cash for stock or shares in such corporation or partnership." In this case there was no tangible property paid in by either partner for the purpose named or for any other purpose. The collateral deposited by Cartier could not upon any reasonable hypothesis be held to be "tangible property paid in" to the partnership. It was not deposited with, transferred or assigned to the partnership and the partnership never acquired any right, title or property interest therein, legal or equitable. This collateral was deposited with the bank as part of the loan transaction. Cartier never parted with the title of ownership therein. The bank held it, not as owner but as pledgee merely. "(3) Paid-in or earned surplus and undivided profits used or employed in the business exclusive of undivided profits earned during the taxable year."

Whether this partnership used or employed in its business paid-in or earned surplus and undivided profits exclusive of undivided profits earned during the taxable year is a question of fact. The trial court found as a fact that at the beginning of the taxable year the liability of the firm exceeded its assets by the sum of $7,218.85. This court has no authority to determine the weight of the evidence. R. S. Sections 649 and 1011. If the finding of fact made by the trial court is sustained by some substantial evidence, then it must be accepted by this court as a final determination of the facts in issue.

There is practically no dispute in the evidence upon which the trial court made this finding of fact. It had been the custom of each partner, with the consent of the other, practically from the time the partnership was organized, to withdraw earnings of the partnership in advance of the ascertainment of the exact profits and a formal division of the same. These withdrawals were charged against the partners respectively on the partnership books of account, and whenever there was a formal division of the profits the amount due to each partner was credited to his account as against amounts that were withdrawn by him. On the first day of January, 1917, it appeared that Cartier had withdrawn in the aggregate, during the life of the partnership, the sum of $11,556.37, in excess of all sums credited to him. Holland had also withdrawn $18,106.28 in excess of his credits. The evidence further shows that these withdrawals were made in anticipation of a distribution of the profits, to be credited to them as against these withdrawals, that would finally balance their accounts. That this was the purpose and understanding of the partners fully appears

[Former Procedure]

by their testimony, and particularly the testimony of Holland, as follows:

"The Court: It would be liquidated by dividends you declared?

"A. Eventually.

"The Court: And credited yourself with?

"Yes."

In the absence of an express agreement to the contrary, the partnership could not require a partner to return to it his share of the actual profits anticipated by these withdrawals. The strongest inference which anything in this record would justify as to the duties of the partners to each other to repay these items charged against them is that each should repay the amount he had withdrawn in excess of his share of the profits. This would mean in the aggregate $7,218.85, just enough to pay the general debts and leave no surplus. In any event, these profits were drawn by the partners and were not used in the partnership business. The claim that they were used in the partnership business as bills receivable, so they would furnish a basis of credit, is not tenable. These partners were the sole owners of the partnership business and in full control of its affairs; they were each individually liable for all the debts of the partnership, so that whether they were liable to the partnership for the full amount of these withdrawals, regardless of profits, could in no wise affect the security of creditors for the payment of their debts.

It would therefore appear that this finding of the trial court is fully sustained by substantial evidence.

Section 9 [209] of this act provides that in the case of a trade or business having no invested capital (and, of course, that means invested capital within the meaning of the act), or not more than a nominal capital, there shall be levied, assessed, collected and paid, in addition to the taxes under existing law and under this act, in lieu of the tax imposed by Section 201, a tax equivalent to eight per centum of the net income. This section of the act would appear to have been intended to cover just such conditions as are here presented.

For the reasons above stated, this judgment must be reversed and the cause remanded for a new trial in accordance with this opinion.

Page 427

Definition of "trade or business."—

Ruling. Royalties received in 1917 by a taxpayer from a license under a license contract to manufacture, use, and sell certain automobile inventions did not result from a mere ownership of property. The time and attention devoted by the taxpayer during that year and prior years to the invention of automobile devices, the placing of same on the market, and the protection of same were sufficient to constitute

[Former Procedure]

a trade or business within the meaning of section 200 of the Revenue Act of 1917. The royalties were therefore subject to excess profits tax under the provisions of section 209 of the Act. (B. 42-21-1874; A. R. R. 425.)

Where a taxpayer received an amount from a decedent's estate as compensation for services rendered in boarding, caring for, and nursing members of the decedent's family, this compensation was held not to be from a vocation, trade, or business when this was not the regular occupation of the recipient. The opinion of the Solicitor of Internal Revenue quoted in the ruling is as follows:

Ruling. The facts do not fully appear on the record, but it seems that the taxpayer received $35x$ dollars in 1917 in payment of a claim against the estate of B, his relative, covering services, etc., which extended over a period of years from 188– to 190– and from 1911 to 1916. The Unit . . . . holds that of this amount $23\frac{1}{2}x$ dollars is subject to both income tax and excess-profits tax at the 1917 rates, the difference between the amounts being deductible. I concur in the view that this was not a claim on March 1, 1913, because the understanding between the parties was too indefinite and intangible and it does not even appear that accounts were kept. It appears proper, therefore, to subject the $23\frac{1}{2}x$ dollars to income tax. I believe, however, that this income was not derived from a trade or business or vocation within the meaning of the statute and the regulations and therefore is not subject to the excess-profits tax.

Analyzing the taxpayer's statement reproduced on page 1 of the recommendation, which seems to be the only statement of the facts in the record, the claim embraced the following principal items: (1) Services rendered in boarding, caring for, and nursing members of B's family; (2) boarding and caring for teams; (3) use of automobiles, teams, wagons, carriages, servants and employees; (4) expenses incurred at his relative's direction. The taxpayer was permitted to deduct $8x$ dollars representing item (4) and also the expense of collection of claim. The remaining items seem to me to come within clause (a) of the second paragraph of article 8, Regulations 41 ("gains or profits from transactions entered into for profit but which are isolated, incidental, or so infrequent as not to constitute an occupation"), and therefore not to be subject to excess-profits tax. The conclusion is based upon the assumed facts that the taxpayer performed the above kind of services only for his relative, and not for others, had no agreement as to prices or charges, and kept no ac-

[Former Procedure]

counts, but expected to be recompensed in some way and to some extent on his relative's death. If, however, it is true of any of the three items that he performed similar services for others in addition to the services casually and incidentally rendered his relative, it might be held that he was engaged in that particular business, but I find nothing in the record to warrant such finding. Certainly in the absence of any definite agreement between the parties nursing and caring for relatives would not ordinarily be considered a vocation, trade, or business of a person whose regular occupation is that of a farmer. (B. 52-21-1996; A. R. R. 706.)

APPENDIX B

FORMS

APPENDIX B

FORMS

On the following pages will be found reproductions of the forms listed below:

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
Form 843 - Jan., 1922
Comptroller General U. S.
January 18, 1922

IMPORTANT

File with Collector of Internal Revenue where assessment was made. Not acceptable unless completely filled in.

CLAIM FOR

☐ ABATEMENT OF TAX ASSESSED

☐ CREDIT AGAINST OUTSTANDING ASSESSMENTS

☐ REFUND OF TAXES ILLEGALLY COLLECTED

☐ REFUND OF AMOUNTS PAID FOR STAMPS USED IN ERROR OR EXCESS

COLLECTOR'S NOTATION
District
Account number
Date received
Stamp here
Collector of Internal Revenue

State of .... } ss:
County of ....

NOTICE TO COLLECTOR

Collector must indicate in block above the kind of claim, except in Income Tax cases.

Date received by Administrative Unit

Stamp here

TYPE OR PRINT

....
(Name of taxpayer or purchaser of stamps.)

....
(Residence—give street and number as well as city or town and State.)

....
(Business address.)

This deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below with reference to said statement are true and complete:

PERIOD	YEAR
From:	19.....
To:	19.....

1. Business in which engaged ....
2. Character of assessment or tax ....
(State for or upon what the tax was assessed or the stamps affixed.)
3. Amount of assessment or stamps purchased .... $..........
4. Reduction of Tax Liability requested (Income and Profits Tax) .... $..........
5. Amount to be abated .... $..........
6. Amount to be refunded (or such greater amount as is legally refundable) .... $..........
7. Dates of payment (see Collector's receipts or indorsements of canceled checks) ....

(If statement covers income tax liability, items 8-11, inclusive, must be answered.)

8. District in which return (if any) was filed ....
9. District in which unpaid assessment appears ....
10. Amount of overpayment claimed as credit .... $..........
11. Unpaid assessment against which credit is asked; period from .... to .... $..........

Deponent verily believes that this application should be allowed for the following reasons:

....

(Attach additional sheets if necessary.)

Sworn to and subscribed before me this .... day

of ...., 19.....

Signed:

....

....

....
(Title.)

(This affidavit may be sworn to before a Deputy Collector of Internal Revenue or Revenue Agent without charge.)

c2—11704

CERTIFICATES

I certify that an examination of the records of the Bureau of Internal Revenue shows the following facts as to the assessment and payment of the tax:

Name of taxpayer.	Character of assessment and period covered.	List	Year.	Month.	Page.	Line.	Amount.	Date paid.	District in which paid.
							$		

Collector of Internal Revenue.

Assessment Clerk, Commissioner's Office.

I certify that the records of my office show the following facts as to the purchase of stamps:

To whom sold or issued.	Kind.	Number	Denomination	Date of sale or issue.	Amount.	If special tax stamp, state. Serial number	Period commencing—
					$		

Collector .... *District* ....

Schedule Number .... District ....

Allowed or Rejected Number .... (Nature of tax.)

Claimant ....

Address ....

Examined and submitted for action ...., 19....

COMMITTEE ON CLAIMS

Claim examined by—

Claim approved by—

Chief of Division

Amount claimed.... $........

Amount allowed.... $........

Amount rejected.... $........

Schedule No. ....

Claim No. ....

Claim No. ....

Schedule No. ....

3—11701

GOVERNMENT PRINTING OFFICE

Form 1078
Revised Jan., 1921
U. S. Internal Revenue

CERTIFICATE OF ALIEN CLAIMING RESIDENCE IN THE UNITED STATES

(To be filed with withholding agent by alien residing in the United States, for the purpose of claiming the benefit of such residence for income tax purposes.)

THIS CERTIFICATE HAS NO EFFECT ON CITIZENSHIP

EMPLOYER	EMPLOYEE
Name ______	Name ______ (To be filed in by employer.)
Address ______	Street ______
______	City ______ State ______
Date of employment ______	Rate of compensation, $ ______ per {week / month / year} ______

I hereby declare that I am a citizen or subject of ______; that I arrived in the United States on or about ______; that I am living in the United States and have no definite intentions as to when (if at all) I will make another country my home; that the address in the United States where any notices relative to income tax may be sent or mailed to me is as stated above.

Sworn to and subscribed before me this

______ day of ______, 19___

______
(Signature of Employee.)

______

______
(Official capacity.)

2—8596

TREASURY DEPARTMENT
U. S. INTERNAL REVENUE
INCOME TAX Jan., 1922
Form 1127 B

INCOME AND PROFITS TAX BOND

To be filed in connection with an extension of time under Section 250 (f) of the Revenue Act of 1921, for payment of deficiency in tax

KNOW ALL MEN BY THESE PRESENTS that ...., as principal, and ...., as surety, are held and firmly bound unto the United States of America in the sum of ....dollars, lawful money of the United States, for the payment whereof we bind ourselves, our heirs, executors, administrators, successors, and assigns, jointly and severally, firmly by these presents.

WHEREAS, there is due from the above bounden principal certain additional income or profits taxes resulting from a deficiency in tax (not due to negligence or to fraud with intent to evade tax); and

WHEREAS, to exact payment of the deficiency in tax at this time will result in undue hardship to the above bounden principal; and

WHEREAS, section 250 (f) of the Revenue Act of 1921 provides that the Commissioner, with the approval of the Secretary, may extend the time for the payment of such deficiency in tax, or any part thereof, for such period as may be considered necessary not in excess of eighteen months from the passage thereof (November 23, 1921), and provides further that the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted; and

WHEREAS, it appears that the amount of this bond is sufficient to cover the deficiency of tax plus penalty and interest:

NOW, THEREFORE, THE CONDITION OF THE FOREGOING OBLIGATION IS SUCH that if the principal shall on or before the .... day of ...., 192 , pay such deficiency in tax found to be due by the Commissioner, plus penalty and interest, in accordance with the terms of the extension granted, and shall otherwise well and truly perform and observe all the provisions of law and the regulations, then this obligation is to be void, but otherwise to remain in full force and virtue.

Witness our hands and seals this .... day of ...., 192

....[L. S.]

Signed, sealed, and delivered in the presence of—

....[L. S.]
Principal.

....

....[L. S.]
Surety.

....

....[L. S.]
Surety.

Bond recommended for approval. / disapproval.

....
Collector.

Bond approved / disapproved this .... day of ...., 192

....
Commissioner of Internal Revenue.

GOVERNMENT PRINTING OFFICE 2—11694

TREASURY DEPARTMENT
U. S. INTERNAL REVENUE
INCOME TAX—Jan., 1922
Form 1127

Application for Extension of Time for Payment of Deficiency in Tax, under Section 250 (f) of the Revenue Act of 1921.

Commissioner of Internal Revenue:

Through the Collector of Internal Revenue at..

SIR:

Application for an extension of time until .... is hereby requested in which to pay a deficiency in income and profits tax in the amount of $........................, due for the year ended.., on account of an understatement therein not due to negligence or fraud.

The collector demanded payment of the above amount of tax on or before ...., 192

This extension is necessary by reason of the following facts:

....

....

....

....

....

....

....

....

As evidence of the necessity for the extension, I herewith submit a balance sheet showing the condition of my business as of the last day of the preceding month or the last taxable period.

Sworn to and subscribed before me this ....

.... day of ...., 192 ....

Applicant.

....

The collector of internal revenue for your district will advise you of the action of this office and will furnish you with the necessary form of bond, if required by the Department. He will also, upon application therefor, furnish you with a list of approved surety companies.

I hereby recommend the approval / disapproval of this application with—

1. A bond with an approved surety company as surety.
2. Bond with Liberty bonds or other bonds or notes of the United States as security.
3. Without bond.

....

Collector.

(See instructions on back)

GOVERNMENT PRINTING OFFICE 2—11026

Instructions relative to filing application for extension of time for payment of deficiency under Section 250 (f) of the Revenue Act of 1921.

Section 250 (f) of the Revenue Act of 1921 contains a special relief provision which will be in effect for only eighteen months after November 23, 1921, the date of the passage of the act. It provides that in the case of any deficiency in tax revealed on the examination of an income or profits tax return (except where the deficiency is due to negligence or to fraud with intent to evade tax), where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for a period not to extend beyond eighteen months from November 23, 1921. Where such an extension is granted there is to be added as part of the deficiency, in lieu of other interest provided by law, interest at the rate of two-thirds of 1 per cent per month from the time the extension is granted. Where such other interest provided by law, however, is in excess of two-thirds of 1 per cent per month the higher rate will be charged. If the deficiency or any part thereof is not paid in accordance with the terms of the extension agreement there is to be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per cent of the deficiency together with interest on the deficiency at the rate of 1 per cent per month from the time it became payable under the terms of the extension agreement. The extension will be granted only in case the taxpayer establishes to the satisfaction of the Commissioner that without such extension undue hardship will result to the taxpayer. The term "undue hardship" means more than an inconvenience to the taxpayer. It is defined as meaning that substantial financial loss or sacrifice will result to the taxpayer from making payment of the deficiency at the due date. This provision of the statute is applicable only to deficiencies in taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918, or the Revenue Act of 1921, and the deficiency referred to is only such deficiency in tax as is revealed on the examination of an income or profits tax return. It has no application to deficiencies in taxes other than deficiencies in income and profits taxes under the three acts named.

Any application for the extension must be made under oath on Form 1127 in accordance with instructions printed thereon, and must be accompanied by evidence showing that undue hardship to the taxpayer would result if the extension were refused. The extension will not be granted on a general statement of hardship, but in each case there must be furnished a statement of the specific facts showing what, if any, financial loss or sacrifice will result if the extension is not granted. The application, with the evidence, must be filed with the collector, who will at once transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner it will be examined and within thirty days either rejected or tentatively approved.

The application should, wherever practicable, contain a certified statement of assets and liabilities of the taxpayer. Where the application is tentatively approved and a bond is required, it must be filed with the collector within ten days after the notification by the Commissioner that a bond is required. It shall be conditioned for the payment of the deficiency and applicable penalties, if any, and interest in accordance with the terms of the extension to be granted and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds and shall be subject to the approval of the Commissioner. In lieu of such a bond the taxpayer may file a bond secured by deposit of Liberty bonds or other bonds or notes of the United States equal in their total par value to the amount of the deficiency and applicable penalties, if any, and interest, as provided in section 1329 of the Revenue Act of 1921.

2—11696

ATTACH THIS FORM TO YOUR INCOME TAX RETURN FORM 1040A OR 1040 AND FILE IT WITH THE COLLECTOR OF INTERNAL REVENUE.

Page 1.

Form 1040 F.—UNITED STATES INTERNAL REVENUE SERVICE.

SCHEDULE OF FARM INCOME AND EXPENSES

FOR THE YEAR 1921

(Name.)

(Post office and State.)

IF YOUR ACCOUNTS ARE KEPT ON A CASH RECEIPT AND DISBURSEMENT BASIS, FILL IN PAGES 1 AND 3 ONLY.
IF YOU KEEP BOOKS OF INCOME AND EXPENSES ON AN ACCRUAL BASIS, FILL IN PAGES 2 AND 3 INSTEAD.

FARM INCOME FOR TAXABLE PERIOD.

1. Sale of Live Stock Raised on and Products from your Farm.

Kind of animals.	Quantity.	Amount.
Cows		$
Calves		
Bulls		
Steers		
Horses		
Mules		
Colts		
Sheep		
Lambs		
Hogs		
Pigs		
Chickens		
Turkeys		
Ducks		
Bees		
Milk		
Butter		
Cream		
Eggs		
Wool		
Hides		
Honey		
Total		$ (Enter on line 1.)

2. Sale of Crops and Products Grown on your Farm.

Kind of crop.	Quantity.	Amount.
Corn		$
Wheat		
Cotton		
Tobacco		
Cotton Seed		
Sirup		
Total		$ (Enter on line 2.)

3. Other Receipts.

Items.	Amount.
Merchandise rec'd for produce	$
Machine work	
Hire of teams	
Breeding fees	
Total	$ (Enter on line 3.)

4. Sale of Live Stock, Crops, or Other Items Purchased.

Description.	Received.	Cost.	Profit.
	$	$	$
Total			$ (Enter on line 4.)

SUMMARY OF INCOME AND EXPENSES COMPUTED ON A CASH RECEIPT AND DISBURSEMENT BASIS.

1. Sale of live stock and stock products raised	$	7. Expenses (column 1, page 3)	$
2. Sale of crops and crop products grown		8. Expenses (column 2, page 3)	
3. Other receipts		9. Repairs	
4. Sale of stock, or other items purchased		10. Depreciation	
5. Gross Profits	$	11. Total Expenses	$

6. Net farm profit to be reported in Item 5, Form 1040A, or Form 1040 (Item 5 minus Item 11) $

2—11666

FARM INVENTORY FOR INCOME COMPUTED ON AN ACCRUAL BASIS.

Description. (Kind of animals, crops, or other products.)	On Hand at Beginning of Year.		Purchased During Year.		Raised During Year.		Consumed or Lost During Year.		Sold During Year.		On Hand at End of Year.	
	Quantity.	Inventory value.	Quantity.	Amount paid.	Quantity.	Inventory value.	Quantity	Inventory value.	Quantity.	Amount received.	Quantity.	Inventory value.
		$		$		$		$		$		$
Totals		$ (Enter on Line 4)		$ (Enter on Line 5)		$		$		$ (Enter on Line 2.)		$ (Enter on line 1)

SUMMARY OF INCOME AND EXPENSES COMPUTED ON AN ACCRUAL BASIS.

1. Inventory of live stock, crops, and products at end of year	$	7. Expenses (column 1, page 3)	$
2. Sales of live stock, crops, and products during year		8. Expenses (column 2, page 3)	
2a. Other miscellaneous receipts		9. Repairs	
3. Total	$	10. Depreciation	
4. Inventory of live stock, crops, and products at beginning of year $			
5. Cost of live stock and products purchased during year	$	11. Total Expenses	$
6. Gross profits (Item 3 minus the sum of Items 4 and 5)	$		

12. Net farm profit to be reported in Item 5, Form 1040A, or Form 1040 (Item 6 minus Item 11) $

2—11666

FARM EXPENSES FOR TAXABLE PERIOD.

Items.	(1) Amount.		Items.	(2) Amount.	
Hired help for farm	$			$	
Feed, hay, straw, etc					
Seed, plants, etc					
Threshing and baling					
Cotton ginning					
Silo filling					
Milling and grinding feed					
Fertilizers and spraying materials					
Blacksmithing					
Fuel and oil for farm work					
Barrels, bags, crates, and twine					
Taxes (except Federal income taxes)					
Insurance on property other than your dwelling and personal effects					
Interest on farm notes and mortgages					
Water rent					
Rent for farm					
Total	$		Total	$	
	(Enter on line 7.)			(Enter on line 8.)	

REPAIRS AND DEPRECIATION.

Description. (If buildings, state the material of which constructed.)	Age When Acquired.	Date Acquired or Constructed.	Cost, or if Acquired Prior to March 1, 1913, the Fair Market Value on That Date.		Repairs.		Depreciation.	
Farm buildings			$		$		$	
Farm machinery and tools								
Farm fences, drains, ditches, etc.								
Totals			$		$		$	
					(Enter on line 9.)		(Enter on line 10.)	

Remarks:

2—11666

INSTRUCTIONS.

Pages 1 and 3 are to be filled in by farmers who either keep no records or only records of cash receipts and disbursements. Pages 2 and 3 are to be filled in by farmers who keep complete accounts on an accrual basis with inventories to determine net profits. Returns on an inventory basis are not acceptable unless the inventories were actually taken and so recorded at the beginning and end of the taxable period.

If you do not, as a matter of settled practice, keep books of account upon an accrual basis, no attempt should be made to fill out the items in the form relating to inventories, and the omission of those items in that case will not result in an incorrect computation of your farm net profit. If, however, you regularly keep books of account upon an accrual basis, which clearly reflect your net income, you should report the value of your crops and stock on hand at the end of the year in gross profits, as provided on the form.

This schedule may be used by farmers who work their own farms or rent them out on shares, and if two or more farms are owned it may be desirable to fill out a separate schedule for each farm.

Attach this schedule to your income tax return (Form 1040A or Form 1040). You should keep a copy for future reference.

When you have determined the net farm profit, transfer the amount to Item 5 of the income tax return Form 1040A, or Form 1040.

Cash Receipts and Disbursements Basis.

A farmer reporting on the basis of cash receipts and disbursements shall include in his gross income for the taxable year the amount of cash or the value of merchandise or other property received from the sale of live stock and produce which were raised during the taxable year or prior years, also the profits from the sale of any stock or other items which were purchased. The farm expenses will be the actual amounts paid out during the taxable year.

Accrual Basis.

If your farm books of account are kept on an accrual basis, the filing of this form is optional.

For those reporting on the accrual basis, the gross profits are obtained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of stock and products and other miscellaneous receipts, for hire of teams, machinery, etc., during the year, and deducting from this sum the inventory value of stock and products on hand at the beginning of the year plus the cost of stock and produce purchased during the year. The farm expenses will be of the actual expenses incurred during the year, whether paid or not.

Inventory.—If you render a return for the taxable period of 1921 upon an accrual basis, you may value the closing inventory for 1921 according to the farm price method, which contemplates valuation of inventories at market less cost of marketing. In the event the use of the farm price method of valuing your closing inventory for 1921 represents a change in method of taking inventories from that employed by you for 1920, the opening inventory for 1921 should be brought in at the same value as the closing inventory for 1920 (this being the same in effect as valuing the opening inventory on the new basis and crediting income with the excess valuation brought in). If such treatment of your opening inventory for 1921 results, however, in an abnormally large income for 1921, then adjustments in the form of an adjustment sheet attached to your 1921 return may be made of your taxes for 1917 and each succeeding year to 1921, based on the new method of taking inventories (using for each of such years prior to 1921 the same method employed for 1921).

Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis, which necessitates the use of opening and closing inventories for the year in which the change is made. There should be included in the opening inventory all farm products (including live stock) purchased or raised, which were on hand at the date of the inventory, and there must be submitted with the return for the current taxable year an adjustment sheet for 1917 and each year thereafter (prior to the year in which the change is made) based on the inventory method; upon the amount of which adjustments the tax shall be assessed and paid (if any be due) at the rate of tax in effect for each respective year. Where it is impossible to render complete inventories from the beginning of the taxable year 1917, the Department will accept estimates which, in its opinion, substantitally reflect the income on the inventory basis, for the year 1917 and thereafter; but inventories must not include real estate, buildings, permanent improvements or any other assets subject to depreciation.

Income.

All the farm income from whatever source must be reported in this schedule. Anything of value received instead of cash must be treated as income to the extent of its cash value. Thus, the total value of groceries, merchandise, etc., received in exchange for eggs, butter, or other produce must be reported as income.

Hail and fire insurance on growing crops should be included in gross income to the amount received in cash or the equivalent for the crop destroyed.

If you sold your farm or any part of it, report the profit in Item 6 of Form 1040A or Form 1040.

The value of farm produce which is consumed by the farmer and his family need not be reported as income; but expenses incurred in raising produce thus consumed must not be claimed as deductions.

The term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms, also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated farmers. A person cultivating or operating a farm for recreation or pleasure is not regarded as a farmer.

Expenses and Other Deductions.

Labor.—Only that part of the board of hired labor which is purchased should be included as a deduction. The value of products furnished by the farm and used in the board of hired labor is not a deductible expense. Rations purchased and furnished to laborers or share croppers are deductible as a part of the labor expense. Do not deduct the value of your own labor or that of your wife or dependent minor children, unless you report such value as income in Item 1, Form 1040A or Form 1040. Do not deduct amounts paid to persons engaged in household work, except to the extent that the services of such employees are used in boarding and otherwise caring for farm laborers. Services of such employees engaged in caring for the farmer's own household are not a deductible expense.

Fertilizers, manures, etc.—The cost of manures, commercial fertilizers, lime, raw rock phosphate, etc., that were bought during the year may be deducted as an expense.

Taxes.—Do not deduct Federal income taxes nor taxes for any improvement or betterment tending to increase the value of the property. (See Articles 131 to 135, Income Tax Regulations, 1922 edition.) Be ready to show tax receipts for taxes claimed as a deduction. Taxes on your dwelling or household property should be reported in Item 11, Form 1040A, or Item 13, Form 1040.

Interest on indebtedness.—All interest paid on farm mortgages, notes, and other obligations incurred to carry on the farm business should be deducted.

Bad debts.—Report only debts, or portions thereof, arising from sales that have been reported as income, which have been definitely proved within the year to be worthless, or such reasonable amount as has been added to a reserve for bad debts within the year. If you report your farm income on a cash basis, bad debts arising from sales are not an allowable deduction.

Repairs and depreciation.—Depreciation claims should not exceed the actual cost of buildings and equipment (or if acquired prior to March 1, 1913, the fair market value on that date) divided by its probable life in years since acquisition. In computing depreciation do not include the value of farm land nor the land on which farm buildings are located. Do not deduct repairs or depreciation on the dwelling you occupy or on your personal or household equipment. Do not claim as a separate item depreciation on live stock or any other property included in your inventory, as such depreciation is taken care of in the reduced amount of the inventory at the close of the year. Depreciation, however, may be claimed on draft or work animals and animals held for breeding purposes which were purchased and which are not included in your inventory of stock bought or raised for sale.

Losses.—You may deduct in Item 12, Form 1040A, or Item 14, Form 1040, losses of buildings, machinery, and other property not included in your inventory, resulting from fires or other casualties and not compensated for by insurance or otherwise. Losses of property included in your inventory are taken care of by the reduced amount of the inventory at the close of the year. The loss of growing crops by frost, storm, flood, or fire, or the loss of animals raised, is not deductible.

Tools, machinery, and equipment.—The cost of small tools of short life, such as shovels, rakes, etc., may be deducted as an expense. You may deduct expenses of operation, repairs, and depreciation on automobiles used exclusively in farm business. If an automobile is used in farm business for a part of the time only, a corresponding part of the expense may be deducted. Amounts expended for automobiles, farm machinery, farm buildings, or other farm equipment of a permanent nature are not deductible as expenses, as such expenditures are regarded as investment of capital which is returned to the owner through depreciation allowances prorated over the useful life of the property.

Rent paid in crops.—Where a tenant farmer pays his rent to the landlord in form of crops raised on the farm (the agreement being on a crop-share basis), the tenant may not deduct as rent the value of the crop given to the landlord, but he may deduct all amounts paid by him in raising the crop.

2—11666

TREASURY DEPARTMENT
INTERNAL REVENUE BUREAU
Guide Form 1097-M

.... COMPANY

PAGE ....,

STATEMENT SHOWING CALCULATION OF AMORTIZATION OF THE COST OF BUILDINGS, MACHINERY, EQUIPMENT, OR OTHER FACILITIES CONSTRUCTED, ERECTED, INSTALLED, OR ACQUIRED, IN ACCORDANCE WITH THE REQUIREMENTS AS SET FORTH IN REGULATIONS 45 (REVISED)

(a)	(b-1)	(b-2)	(c)	(d-1)	(d-2)	(d-3)	(d-4)	(e-1)	(e-2)	(e-3)	(e-4)	
				TOTAL COST				RESIDUAL VALUE				
					Expended Subsequent to April 6, 1917				Apportioned to Period Subsequent to April 6, 1917			
DESCRIPTION OF PROPERTY	Date of acquirement or date when construction, erection, or installation was begun	Date on which construction, erection, or installation was completed for operation	Reference or voucher No.	Expended prior to April 6, 1917	Total subsequent to April 6, 1917	Depreciation or losses sustained prior to Jan 1, 1918	Depreciated cost on which amortization is based, column (d-2) less (d-3)	Apportioned to period prior to April 6, 1917	Estimated value in use in going business	If property has been sold, amount received	If property has been discarded, estimated salvage value	Amount to be amortized, column (d-4) less column (e-2), (e-3), or (e-4)

THIS FORM SHOULD BE RENDERED IN DUPLICATE.

In addition to the above data, taxpayer should give full explanation of the basis upon which the amortization deduction is computed. The application of any percentage to the original cost to reduce same to prewar or problematical postwar values is not acceptable. See Article 184, Regulations 45 (revised). Any statement that the amortized cost is the "Estimated value in use" of the facility under consideration must be fully supported.

This form is intended solely in the nature of a guide, for use in the preparation of the itemized schedule required in support of deductions as amortization. The data to be furnished need not necessarily be placed upon the form itself. In numerous cases one or more of the columns on the guide form may not be required. The itemized amortization schedule should be so arranged, however, as to follow the outline of this guide form.

Form 1086.
Revised Jan., 1922.
U. S. Internal Revenue Service.

OWNERSHIP AND EXEMPTION CERTIFICATE–FOREIGN CORPORATION.

(For use of foreign corporations having an office or place of business in the United States.)

PERSON PAYING INCOME.

Name ....

Address ....

....

INSTRUCTIONS.

I hereby declare that the foreign corporation named above (of which I am an officer) has an office or place of business in the United States, and that under the provisions of the income tax law the income reported hereon is not subject to having any tax withheld at the source of the income, and that all the information given hereon is true and correct.

Date ....

By ....
(Signature of person duly authorized to sign and his official position.)

FOREIGN CORPORATION ENTITLED TO RECEIVE INCOME.

Name ....

Address in United States ....

....

KIND OF INCOME AND AMOUNT PAID.

Rent, Royalties	$	
Interest		
Commissions		
Other income		

GOVERNMENT PRINTING OFFICE 2—11718

A nonresident alien who desires to claim the personal exemption of $1,000 with respect to salaries or wages received in payment for services rendered in the United States should file this form with his employer not later than February 1 succeeding the year during which the income was received.

THE WITHHOLDING AGENT OR COLLECTOR RECEIVING THIS CLAIM SHALL ENTER DATE OF RECEIPT IN THIS SPACE.

Form 1115—Revised January, 1922
UNITED STATES INTERNAL REVENUE SERVICE

CLAIM BY NONRESIDENT ALIEN INDIVIDUAL

FOR BENEFIT OF PERSONAL EXEMPTION OF $1,000

FOR TAXABLE YEAR 1921

DO NOT WRITE HERE

(Name of withholding agent.) (Street and number.)

(City or town.) (State.)

Claim is hereby made for benefit of the personal exemption provided under section 216 of the Revenue Act of 1921 by (or for)—

Name of claimant

Address in the United States.

1. Of what country are you a citizen or subject? (Name of country.)
2. State or Province? (Name of State or Province.) 3. Are you single?
4. If married, has your wife or husband derived income during the taxable year to date from sources in the United States separate from your own?
5. If so, is such income included in the income stated below?
6. Have you filed a return of net income for all or any of the past four years? 7. If so, state for which years and the Internal Revenue Districts in which filed

INCOME OF CLAIMANT, DURING TAXABLE YEAR TO DATE, FROM SOURCES WITHIN THE UNITED STATES.

(1) SALARY OR WAGES.

NAME OF EMPLOYER.	ADDRESS.	PERIOD.	AMOUNT.	
			$	
				$

(2) OTHER INCOME.

NAME OF SOURCE.	ADDRESS.	PERIOD OR DATE.	AMOUNT.	
			$	
				$

Total income of claimant, during taxable year to date, from sources within the United States (X) $

STATEMENT OF PERSONAL EXEMPTION CLAIMED.

Amount of personal exemption to which entitled (Y) $ 1,000 00

Total income of claimant, during taxable year to date, from sources within the United States (item X from above)

Balance of credit (item Y minus item X) $

NOTE.—For the taxable year 1921, and subsequent years, only $1,000 personal exemption is allowed a nonresident alien individual, regardless of whether he is single, married, or the head of a family, and regardless of nationality. No credit is allowed for dependents.

I swear (or affirm) that the above is, to the best of my knowledge and belief, a true and complete statement of facts in connection with the claim for credits above made.

(If claim is made by agent the reason therefor must be stated on this line.)

Sworn to (or affirmed) and subscribed before me this .... day of 192

(Signature of individual or agent.)

(Official capacity.) GOVERNMENT PRINTING OFFICE (Address of individual or agent.) 02—11639

Form 1099
U. S. Internal Revenue
Revised January, 1922

INFORMATION AT THE SOURCE, 1921

NAMES MUST BE LEGIBLE
TYPED OR PRINTED

REPORT OF INCOME OF $1,000 OR MORE PAID DURING THE CALENDAR YEAR 1921

SALARIES, WAGES, RENT, INTEREST, OR OTHER FIXED OR DETERMINABLE GAINS, PROFITS, AND INCOME

BY WHOM PAID	TO WHOM PAID
NAME	NAME ....
STREET	STREET ....
CITY .... STATE	CITY .... STATE ....

INSTRUCTIONS TO PAYORS

Fill in one of these forms for each person, partnership, personal service corporation, or fiduciary to whom income, as described on this form, was paid.

Forward with return Form 1096 so as to reach the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., on or before March 15, 1922.

Do not report on this form dividends on stock, interest on bonds of domestic or foreign corporations, or interest on bonds and other obligations of the United States or foreign countries.

FOR FURTHER INSTRUCTIONS SEE FORM 1096 c2—11654

KIND OF INCOME PAID	AMOUNT PAID		
Salaries, wages, fees, commissions, etc	$	......	......
Rents and royalties	$	......	......
Interest on notes, mortgages, etc	$	......	......
Premiums and annuities	$	......	......

Form 1096
(Revised January, 1922)

UNITED STATES INTERNAL REVENUE SERVICE

ANNUAL INFORMATION RETURN

OF PAYMENTS OF INCOME, ETC., REQUIRED TO BE REPORTED UNDER REVENUE ACT OF 1921

FOR CALENDAR YEAR 1921

(Return for Fiscal Year Can Not Be Accepted)

FOR INSTRUCTIONS SEE REVERSE SIDE

THIS RETURN, ACCOMPANIED BY REPORTS ON FORM 1099, MUST BE FORWARDED SO AS TO REACH THE COMMISSIONER OF INTERNAL REVENUE, SORTING SECTION, WASHINGTON, D. C., ON OR BEFORE MARCH 15, 1922.	(Name of person or organization rendering this return.) (Street and number or rural route.) (City.) (State.)	(Date received in Sorting Section)

A	B
CHARACTER OF INCOME PAID.	NUMBER OF REPORT FORMS 1099 ATTACHED.
Interest, rent, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable gains, profits, and income of $1,000 or more	

(DO NOT WRITE IN THIS SPACE.)

IMPORTANT NOTICE

Returns of information are required to be rendered on the basis of the calendar year. Returns for any other period of time will not be accepted.

If list showing names and addresses of payees is compiled or an adding machine tape used in executing Forms 1099. it should be submitted with forms.

The name of the individual, corporation, partnership, etc., using Form 1099 may be printed or stamped on each form, if so desired.

Returns of individuals on this form must be signed and sworn to by the individual or his duly authorized agent. Returns of corporations, partnerships, etc., must be signed and sworn to by an officer of the corporation or member of firm.

I swear (or affirm) that to the best of my knowledge and belief the foregoing return and the accompanying reports constitute a true and complete statement of payments of the above-described classes of income made by the person or organization named at the head of this return during the calendar year 1921

Sworn to and subscribed before me this .... day of ...., 1922.

(Signature.)

(State whether individual owner, member of firm, or disbursing officer of Government bureau or office, or if officer of corporation give title.)

(Signature.)

62—11668 (Title.)

(State address of person signing if different from that given at head of return.)

(THIS RETURN MUST BE SIGNED AND SWORN TO.)

INSTRUCTIONS

Forms 1096 and 1099 (Interest, Rent, Salaries, etc., of $1,000 or more) must be made by every individual, corporation, partnership, personal service corporation, association, or insurance company, including lessees or mortgagors of real or personal property, trustees, executors, administrators, receivers, employers, and all officers and employees of the United States who paid interest, rent, salaries, etc., to another individual, partnership, personal service corporation, or fiduciary during the calendar year 1921. A separate report on Form 1099 must be made (and forwarded with this return) for each individual, partnership, personal service corporation, or fiduciary to whom such income was paid, credited, or distributed.

Interest, rent, salaries, etc., regardless of amount paid to nonresident alien individuals, should not be included in this return but should be reported on return Form 1042.

In executing Form 1099, an employer who is required to withhold tax from an employee under a State income tax law, should report on each form the amount of salary paid to the employee plus the amount of tax withheld. The employee should report the same amount on Form 1040 or Form 1040A, as the case may be.

ORGANIZATIONS HAVING A MAIN OFFICE OR PLACE OF BUSINESS, AND ONE OR MORE BRANCH OFFICES, SHOULD FILE COMPLETE RETURNS ON FORMS 1096 AND 1099 SHOWING ALL PAYMENTS MADE BY MAIN AND BRANCH OFFICES. THIS RETURN SHOULD BE MADE FROM THE MAIN OFFICE AND THE LOCATIONS OF ALL BRANCH OFFICES COVERED BY THE RETURN SHOULD BE NOTED THEREON.

Reports on Form 1099 are not required in the following cases:

Interest on the obligations of the United States, of States, Territories, or political subdivisions thereof or of the District of Columbia, and compensation paid officers and employees by a State or political subdivision thereof for personal services.

Bills paid for merchandise, telegrams, telephone, freight, storage, and similar charges.

Amounts paid to employees for expenses incurred in business.

Premiums paid to insurance companies.

Annuities representing return of capital.

Interest accrued on bank deposits if not credited.

Payments made by domestic establishments or foreign branch houses thereof to nonresident alien employees for services performed entirely in foreign countries.

Interest on bonds of domestic and foreign corporations. (See Forms 1012 and 1096A.)

Salaries, wages, etc., paid to nonresident alien individuals and foreign corporations. (See Form 1042.)

The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as a part of his compensation.

Distributions to members of a partnership, personal service corporation, and beneficiaries. (Distributions made to members of partnerships, personal service corporation, and to beneficiaries of estates or trusts must be shown on Partnership and Fiduciary Returns.)

TENANTS ARE NOT REQUIRED TO REPORT PAYMENTS OF RENT MADE TO REAL ESTATE AGENTS OR REPRESENTATIVES, BUT AGENTS OR REPRESENTATIVES ARE REQUIRED TO REPORT PAYMENTS TO LANDLORD OR OWNER IF THEY AMOUNT IN THE AGGREGATE TO $1,000 OR MORE FOR THE YEAR.

3—11668

TREASURY DEPARTMENT.
INTERNAL REVENUE SERVICE
Form 707—Revised Feb., 1921.

TO BE STAMPED BY COLLECTOR SHOWING DISTRICT AND DATE RECEIVED

1922 RETURN

CAPITAL STOCK TAX

RETURN FOR DOMESTIC CORPORATIONS

(SEC. 1000, TITLE X, REVENUE ACT OF 1918)

File with Collector of Internal Revenue for your district on or before July 31, 1921, to avoid penalty.

(Collection district.)
Assessment List, Form 23 A.

(Month.) (Year.)

(Page.) (Line.)

Audited by:

1. Name (Print name of corporation, joint-stock company, or association.) (Show former name, if changed.)
2. Address (The address must be that of the principal place of business.) (Street and number.) (City or town, and State.)
3. Name of parent company (District filed)
4. Name of subsidiary (or attach list and state districts where filed.) (District filed)
5. Nature of business in detail
6. Incorporated or organized in State of Month Year
7. Return as of close of fiscal year ended { June 30, 1921, or (Nearest earlier date.) } Fire insurance carried, if any, $ (As of date, line 7.)

(See Special Instructions No. 2, page 4 hereof.)

		Cum. or noncum.	Dividend rate.	Number of shares.	Par value per share.	Total par value.	Total.
	Capital stock outstanding:						
8.	Common		%		$	$	xxx xx xxx xx
9.	First preferred		%				xxx xx xxx xx
10.	Second preferred		%				xxx xx xxx xx
11.	Total						$
12.	Amount of surplus						
13.	Amount of undivided profits						
14.	GRAND TOTAL						

TAX PAYABLE ANNUALLY IN ADVANCE

RETURN FOR TAXABLE PERIOD JULY 1, 1921, TO JUNE 30, 1922, BASED ON FAIR AVERAGE VALUE OF CAPITAL STOCK FOR PRECEDING YEAR

CAREFULLY READ ALL INSTRUCTIONS BEFORE MAKING RETURN

COMPUTATION OF TAX.	This column for use of taxpayer.	This column for use of Department.
Domestic corporations will report: 15. **Fair value of total capital stock for fiscal year determined by Exhibit**	$	$
Domestic mutual insurance companies will report: 16. (*a*) Sum of surplus or contingent reserves maintained for general use of the business; (*b*) Plus any reserves the net additions to which are included in net income under the provisions of Title II, Revenue Act of 1918	$	$
17. Total		
18. Deduction allowed by law	5 000 00	5 000 00
19. Amount in excess of $5,000 (Omit cents.)	xx	xx
20. Tax at rate of $1 for each full $1,000 in excess of $5,000 (Omit cents.)	xx	xx
21. Penalty		
22. TOTAL TAX AND PENALTY		

CLAIM SETTLEMENT RECORD

AMOUNT	$
ALLOWED	$
REJECTED	$
FAIR VALUE	$
BASIS	

Every corporation must file a return or submit conclusive evidence that it is not liable. Determination of liability rests with the Commissioner. This applies to companies claiming exemption on account of not being engaged in business or as personal service corporations, etc., under Section 231, Title II, of the Revenue Act of 1918. See Arts. 28 and 31, Regulations 50, Revised.

ADDITIONAL ASSESSMENT RECORD

, 19 LIST
PAGE LINE
ADDITIONAL TAX, $
BY

DO NOT PASTE RIDERS TO FACE OF RETURN.

ALL TAXES ARE PAYABLE TO THE COLLECTOR OF THE DISTRICT IN WHICH RETURN IS FILED.

(SEE INSTRUCTIONS ON PAGE 4.)

(1)

EXHIBIT A. (See Special Instructions No. 4, page 4.)

CONDENSED BALANCE SHEET AS OF ....
(Same date as Item 7, page 1.)

BANKS AND INSURANCE COMPANIES MAY ATTACH PRINTED STATEMENTS.

DEBITS AND ASSETS.	BOOKS OF ACCOUNT.	FAIR VALUE.	DIFFERENCE. * (Explain any large amounts.)
Real estate	$	$	$
Buildings			
Machinery			
Securities			
Cash			
Notes receivable			
Accounts receivable			
Inventory			
Other assets			
Good will, patents, etc.			
Deferred charges			
TOTALS	$	$	$

CREDITS AND LIABILITIES.	BOOKS OF ACCOUNT.	FAIR VALUE.	DIFFERENCE.
Bonded debt .... $			
Less in Treas.	$	$	$
Mortgages			
Accounts payable			
Notes payable			
Other liabilities			
Reserves			
Depreciation			
Depletion			
Taxes			
Deferred credits			
Capital stock:			
Preferred .... $			
Less in Treas.			
Common .... $			
Less in Treas.			
Surplus			
Profit and loss			
TOTALS	$	$	$

RECAPITULATION OF EXHIBIT A	This column for use of taxpayer.	This column for use of Department.
DOMESTIC CORPORATIONS		
Total of debits and assets *after deducting items not actual assets*	$	$
Less total of credits and liabilities *after deducting capital stock, surplus, and other items not actual liabilities*		
STOCK INSURANCE COMPANIES		
Fair value of assets		
Less actual liabilities and reserves, including deposits		
Difference (value of total capital stock reflected by Exhibit A)	$	$

* Material differences will not be allowed unless satisfactorily explained

(SEE INSTRUCTIONS ON PAGE 4.)

EXHIBIT B. (See Special Instructions No. 5, page 4.)

QUOTATIONS OR OUTSIDE SALES PRICES .... (Give name of exchange or specify "Outside sales.")

MONTH.	COMMON. Number of shares outstanding.	COMMON. Price.	FIRST PREFERRED. Number of shares outstanding.	FIRST PREFERRED. Price.
		$		$
Total				
Average	x x x x x x		x x x x x x	

SPECIAL INFORMATION.

Manufacturing and trading corporations will report annual gross sales for the five years shown under Exhibit C.

FISCAL YEAR ENDED—	SALES.
191	$
191	
191	
19	
19	

RECAPITULATION OF EXHIBIT B.	This column for use of taxpayer.	This column for use of Department.
Average sale value of common stock per share, $........, multiplied by .... number of shares outstanding	$	$
Average sale value of first preferred stock per share, $........, multiplied by .... number of shares outstanding		
Average sale value of second preferred stock per share, $........, multiplied by .... number of shares outstanding		
TOTAL (value of total capital stock reflected by Exhibit B)		

Approximate number of shares traded in during the year: Common .... Preferred ....

Capital stock outstanding as of June 30, 1921: Common .... Preferred ....

EXHIBIT C. (See Special Instructions No. 6, page 4.)

ANNUAL INCOME.

FISCAL YEAR Ended—	NET INCOME. (Deficit in red.)	DEDUCTIONS.	ADDITIONS.	ADJUSTED INCOME.	NUMBER OF SHARES.	DIVIDENDS DECLARED. Common.	DIVIDENDS DECLARED. First preferred.	DIVIDENDS DECLARED. Second preferred.	DEPRECIATION.
191	$	$	$	$		%	%	%	$
191						%	%	%	
191						%	%	%	
19						%	%	%	
19						%	%	%	
Total									
Average	$	x x x x x x	x x x x x x	$		%	%	%	$

RECAPITULATION OF EXHIBIT C.	This column for use of taxpayer.	This column for use of Department.
Average annual income as adjusted	$	$
Capitalized at .... per cent (value of total capital stock reflected by Exhibit C)		

STATE OF .... }
COUNTY OF .... } ss.

We, ..., President, and ...., Treasurer, of the above-named company, whose return for special excise tax is herein set forth, being severally duly sworn, each for himself, deposes and says that the items entered in the foregoing report and in any additional list or lists attached to or accompanying this return are, to his best knowledge and belief and from such information as he has been able to obtain, true and correct.

Sworn to and subscribed before me this .... day of ...., 19......

.... *President.*

[SEAL.] .... (Official capacity.)

.... *Treasurer.*

(SEE INSTRUCTIONS ON PAGE 4.)

SPECIAL INSTRUCTIONS

1. Required Value.—The capital stock tax except on domestic mutual insurance companies is measured by the fair value of the total capital stock for the year preceding the taxable year, whether or not it is organized for profit or has a capital stock represented by shares. For domestic mutual insurance companies, see page 1, Form 707, Revised.

For the purpose of this tax the fair value of the entire capital stock as a going concern, regardless of stock ownership or the ability of individual stockholders to liquidate their holdings, is required. The sales prices for any number of shares of stock less than a majority interest are not necessarily indicative of the fair value of the entire capital stock. The book value, the kind of assets (slow or quick turning), the nature of the business, good will, franchises, earning capacity, etc., are important factors that affect the worth of enterprises and must be given due consideration in arriving at the fair value at any given date.

In order that consideration may be given the various factors affecting fair value, three exhibits are provided for furnishing information, and the taxpayer will complete each exhibit or state why the required data are not available.

Exhibit A provides for adjusting any overstated or understated values contained in the taxpayer's books of account, and Exhibit C provides for showing an adjusted income, which should be the actual operating income to be used for capitalizing on a percentage basis, fixed by its officers as fairly representing conditions obtaining in the trade and in the locality. If the reconstructed book value shown by Exhibit A, the market value shown by Exhibit B, or the valuation reflected by Exhibit C is greater than the valuation returned by the taxpayer, a comprehensive statement showing any extraordinary conditions which are relied on in support of the valuation claimed must be submitted. In any case in which the fair value is understated the amount will be redetermined by the Commissioner and the correct tax assessed; also any penalty incurred will be asserted.

2. Closing Date of Fiscal Year.—In item 7, on page 1 hereof, the taxpayer will show the closing date of its fiscal year ended between July 1, 1920, and June 30, 1921, if other than June 30, and the information furnished under Exhibits A, B, and C will be as of the year or years ended on such date, which should be used annually.

Mutual insurance companies will show June 30 or the nearest earlier date of the closing of the preceding accounting period used by such company for purpose of making its income-tax return.

3. Exhibits.—The three exhibits, A, B, and C, are provided to indicate the information desired and the manner in which it should be furnished. So far as adaptable these forms should be completed by taxpayers, but if they find it more convenient they may attach to this return their own statements (as in the case of banks and insurance companies), provided substantially the same information is furnished. In any event, taxpayers should attach any additional statements that will aid in a comprehensive understanding of the taxpayer's return, so that the Commissioner of Internal Revenue may equitably determine the correctness of the fair value reported in item 17 on page 1 hereof.

4. Exhibit A: Condensed Balance Sheet.—Furnish under Exhibit A a condensed balance sheet as of the closing date of the fiscal year given in item 7 on page 1 hereof.

"Books of account."—These columns must show the amounts as carried in the taxpayer's books of account.

"Fair value."—Refer to article 1 above, defining the value required, and in the event that the columns "Books of account" contain any overstated or understated values, show herein the actual values.

"Difference."—These columns will show the difference between the columns "Books of account" and "Fair value." Any material differences *must be explained* in such manner as to enable the Commissioner of Internal Revenue to determine if they are proper and acceptable. For this purpose the differences shown herein need not be covered by corresponding adjustments in the taxpayer's books of account.

"Treasury stock" and "Treasury bonds."—In the event the taxpayer holds in its treasury any of its own stock or bonds, advice must be furnished as to whether such stock and bonds are pledged or unpledged.

"Other assets" and "Other liabilities."—If material amounts are shown, a comprehensive analysis of them must be attached.

"Profit and loss."—If the "Profit and loss" balance is a debit, the amount should be shown in red.

Reserves for the payment of future dividends, whether declared or not, will not be considered as liabilities, but a reasonable amount to cover the preceding dividend period may be so considered if the dividend has been declared and not disbursed. If deducted, show date declared and date of actual payment.

5. Exhibit B: Quotations or Outside Sales Prices.—Furnish under Exhibit B the prices quoted on a recognised stock exchange or on the New York curb, or the prices at which outside sales were made if the stock is not listed, for the period of 12 months ending with the close of the taxpayer's fiscal year given in item 7 on page 1 hereof.

If the stock is listed, the name of the exchange from which reported quotations are taken must be shown in the space provided therefor, and the prices reported will be the mean of the highest and of the lowest bid price during each month, from which the average for the year will be obtained. If the taxpayer prefers, a schedule may be attached to this return showing the highest and lowest bid price at which stock was quoted for each day of the year and the average obtained therefrom.

If the stock is not listed and outside sales have been made at prices known or determinable by the officers making this report, such prices will be reported herein. A statement of the number of shares involved and the conditions under which sales were made at other than exchange quotations must accompany this return. Sales to employees or directors for qualifying purposes, or sales which are restricted as to resale, or sales at prices otherwise specially influenced, will not be considered representative of the fair value of the entire capital stock and should not be included.

In the column "Number of shares outstanding" should be shown the total number of shares outstanding at the close of each month. The average value per share will be determined as follows:

First. If no change occurred in the number of shares outstanding during the year, total the quotations or sales prices for the months reported and divide by the number of months in which quotations or sales prices are shown.

Second. If any change occurred in the number of shares outstanding during the year, total the quotations or sales prices for the months reported during which the number of shares outstanding at date of incidence of the tax has been outstanding and divide by the number of months used in the computation.

6. Exhibit C: Annual Income.—Furnish under Exhibit C the annual income and other data for the five fiscal years ended with the close of the taxpayer's fiscal year as given in item 7 on page 1 hereof, or for the period during which the corporation has been engaged in business if for a shorter period.

"Net income."—In this column will be shown the income returned for the purpose of the income tax and excess profits tax.

"Deductions" and "Additions."—Refer to article 1 of these Special Instructions, and show in these columns such amounts as should be deducted from or added to "Net income" to arrive at the adjusted income which may be capitalized to determine the fair value of the capital stock. A comprehensive analysis of any amounts reported therein should be attached to this return. Some of the principal items frequently requiring adjustment are:

Deductions:
- Income and profits taxes not deductible in computing income subject to tax.
- Depreciation and depletion.
- Interest charges not deductible in computing income subject to tax.
- Losses not fully deductible, in computing income subject to tax.

Additions:
- Dividends from other corporations not included in computing income subject to tax.
- Income from securities of a State, municipality, or of the United States, not included in the income-tax return.
- Expenditures made for additions and betterments, or reserves for such purposes, made against income, whether direct or through expenses.

"Adjusted income."—This column will reflect the amounts resulting from the adjustment of the amounts shown in the three preceding columns.

"Number of shares."—Herein should be given the total number of shares of all classes of stock outstanding at the close of each fiscal year.

"Dividends declared."—Herein should be reported the percentage of dividends declared on the par value of each class of stock outstanding each year. The amount represented by the percentages shown in this column must not be deducted from the columns "Net income" or "Adjusted income."

"Depreciation."—Hereunder will be reported the amount actually charged against income each year in the taxpayer's books of account for depreciation.

"Depletion."—In the case of mines, oil and gas wells, other natural deposits, and timber, valuations reported as the basis of depletion in computing Federal income and profits taxes should be shown in the "Fair value" column.

Capitalizing net income.—The officers making the return will capitalize the average annual income on a percentage basis that fairly represents, under the conditions obtaining in the trade in the locality, what representative enterprises must earn in order to maintain their stock at par. In other words, if enterprises engaged in a similar business must on the average earn 12 per cent on their issued capital stock to keep the value of their stock at par, the net income should be capitalized by dividing it by .12.

7. Domestic insurance companies (other than mutual companies) must attach to the return a list of such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders, stating the name and amount of each such deposit or fund.

8. Domestic mutual insurance companies must attach to the return a supplementary list showing the name and amount of each reserve, the net additions to which are included in the net income.

GENERAL INSTRUCTIONS

1. Nature of Tax.—The capital stock tax due July 1, 1921, is an excise tax payable in advance for the privilege of doing business from July 1, 1921, to June 30, 1922.

2. Date of Filing Returns.—During the month of July and annually thereafter.

3. Tentative Return.—Filing of a tentative return will avoid penalty for delinquent filing, but does not authorize withholding of the tax. Complete return as far as possible and submit an approximate estimate as a basis in order that an initial assessment may be made. See Art. 34, Reg. 50, Revised.

4. The Collector May Make Return.—If any corporation or association fails to make and file a return within the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return, the collector or his deputy is authorized to make the return from such information as he can obtain through testimony or otherwise. Such return, when subscribed by the collector or his deputy, shall be prima facie good and sufficient for all legal purposes.

5. Extension of Time.—If on account of sickness or absence of the officer charged with making the return it is impossible to prepare and file a return on or before July 31, the collector, upon application in writing, may allow an extension of not exceeding 30 days for making and filing the return. If extension is granted, the letter of the collector should be attached to the return.

6. Signatures and Verification.—Returns must be signed and verified by two officers of the corporation, that is, by the president, vice president, or other principal officer, and by the treasurer or other financial officer, and must be sworn to before an officer authorized to administer oaths, and the seal of the attesting officer, if he is required to have a seal, must be impressed on the return. The name of the corporation and the names of the officers signing the return should be plainly written or printed on the return.

7. Tax.—From the total fair average value of the capital stock the sum of \$5,000 is deductible and the tax is at the rate of \$1 for each full \$1,000 of any balance except in the case of mutual insurance companies (see lines 16 to 20 on page 1).

8. Penalties.—In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount. The amount of the tax is payable to the collector at any time after July 1, 1921, but penalties for nonpayment do not attach until ten days after notice and demand has been served by the collector upon the taxpayer.

9. Regulations.—For further information regarding the tax see Regulations No. 50, Revised.

Form 1120
U. S. INTERNAL REVENUE

THIS RETURN SHOULD BE FILED NOT LATER THAN THE 15TH DAY OF THE THIRD MONTH FOLLOWING THE CLOSE OF THE TAXABLE PERIOD

CORPORATION INCOME AND PROFITS TAX RETURN

FOR CALENDAR YEAR 1921

Page 1 of Return
(DO NOT WRITE IN THESE SPACES)
Examined by

FIRST PAYMENT
$

Cashier's Stamp

CASH CHECK M.O. CERT. OF IND

Or for period begun ...., 1920, and ended ...., 1921

PRINT PLAINLY CORPORATION'S NAME AND BUSINESS ADDRESS

(Name)

(Street and number)

(Post office and State)

KIND OF BUSINESS .... IS THIS A CONSOLIDATED RETURN? ....

SCHEDULE A—TAXABLE NET INCOME.

GROSS INCOME.

1 Gross sales less returns and allowances .... $
2 Less cost of goods sold, exclusive of items called for separately below (from Schedule A2) .... $
3 Gross income from operations other than trading or manufacturing, less allowances (from Schedule A3)
4 Taxable interest on Liberty Bonds, etc. (from Schedule A4) ....
5 Taxable interest from all other sources ....
6 Rents ....
7 Royalties ....
8 Share of net income earned by personal service corporation (whether received or not)
9 Dividends on stock of foreign and domestic corporations
10 Gross income from all other sources (not including any amount reported in Item 23 below) (from Schedule A10) ....
11 TOTAL OF ITEMS 1 TO 10 .... $

DEDUCTIONS.

12 Expenses (except amounts reported in Item 2 above or called for separately below) (from Schedule A12) .... $
13 Compensation of officers (in whatever form paid) (from Schedule A13)
14 Repairs (including labor, supplies, etc.) (from Schedule A14)
15 Interest (see page 2 of Instructions, paragraph 9)
16 Taxes (from Schedule A16)
17 Bad debts (from Schedule A17)
18 Exhaustion, wear and tear (including obsolescence) (from Schedule A18) ....
19 Depletion (from Schedule A19)
20 Amortization of war facilities (from Schedule A20)
21 TOTAL OF ITEMS 12 TO 20
22 ITEM 11 MINUS ITEM 21 .... $
23 Profit or loss on sales of capital assets and miscellaneous investments (from Schedule A23) .... $ .... $
24 Losses by fire, storm, etc. (From Schedule A24) Extend difference between or sum of Items 23 and 24
25 Net income exclusive of deductions for dividends (Item 22 minus 24 extended) .... $
26 Dividends deductible under Section 234 (a) 6 of the Revenue Act of 1921 (from Schedule A26) ....
27 NET INCOME (Item 25 minus Item 26) If return is for a period less than twelve months, see page 1 of Instructions, paragraph 10 .... $

SCHEDULE B—INVESTED CAPITAL.

1 Capital, surplus, and undivided profits at beginning of taxable period (from Schedule E, Item 1) .... $
2 Plus adjustments by way of additions (from Schedule F, Item 1) .... $
3 TOTAL .... $
4 Less adjustments by way of deductions (from Schedule G, Item 7) ....
5 REMAINDER .... $
6 Plus or minus changes in invested capital during taxable period (Net Increase or Decrease from Schedule H) ....
7 TOTAL OR REMAINDER
8 Less deduction on account of inadmissible assets (from Schedule J) ....
9 Invested capital for taxable period .... $

SCHEDULE C—EXCESS PROFITS CREDIT.

1 Eight per cent of invested capital for taxable period (Item 9 of Schedule B) ....
2 Exemption ($3,000), except for a foreign corporation or a corporation satisfying the conditions [illegible]
3 Excess Profits Credit (Item 1 plus Item 2) .... $

SCHEDULE D—COMPUTATION OF TAXES.

1. TAX STEP	2. NET INCOME (ITEM 27 SCHEDULE A)	[illegible]	[illegible] TAX	RATE	[illegible] TAX
1 Net income not in excess of 20% of invested capital	$	$	$	20%	$
2 Balance of net income				40%	
3 Totals computed under Section 301 (a)	$	$	$		
4 Excess Profits Tax (if computed under sections 302, 303, 304 or 327 of the Revenue Act of 1921 see page 2 of Instructions, paragraph 1[illegible])					$

5 Net income (Item 27, Schedule A) .... $
6 Less taxable interest on obligations of United States (Item 4, Schedule A) $
7 Excess profits tax (Item 3 or 4 whichever [illegible] Schedule D), or
8 [illegible] Item [illegible] Form [illegible]
9 Exemption $2,000 for domestic corporation [illegible] exceeding $25,000
10 Balance (Item 5 less Items 6, 7, and 9, or Items 6, 8, and 9) $

11 Income tax (10% of Item 10) .... $
12 If net income does not exceed $[illegible] [illegible] amount thereof ($2,000) .... $
13 Total tax (Item [illegible] the lesser [illegible])
14 [illegible] Income and profits taxes paid [illegible] $
15 Tax [illegible] of the [illegible] Act [illegible]
16 Balance of tax (Item 13 minus Items 14 and 15) .... $

An amended return must be plainly marked "Amended."

Checks and drafts will be accepted only if payable at par.

SCHEDULE E.—CAPITAL, SURPLUS, AND UNDIVIDED PROFITS AS SHOWN BY BOOKS BEFORE ANY ADJUSTMENTS ARE MADE THEREIN

[illegible]

Item	Amount
Capital stock [illegible]	
1. First preferred	
2. Second preferred	
3. Common	
4. Total	
Surplus and undivided profits:	
5. Paid-in surplus	
6. Earned surplus and undivided profits	
7. Reserves [illegible] (to be reconciled with balance sheet items)	
8. Other items to be detailed	
9. Total of items 4, 5, 6, 7, and 8	
10. Deduction on account of treasury stock	
11. [illegible]	

SCHEDULE F.—ADJUSTMENTS BY WAY OF ADDITIONS

F1. If an addition to invested capital is claimed in Item 1 [illegible]

F2. If an addition to invested capital is claimed in Item [illegible]

F3. [illegible]

Item	Amount
1. [illegible]	
2. [illegible]	
4. Total	

SCHEDULE G.—ADJUSTMENTS BY WAY OF DEDUCTIONS.

G1. [illegible]

G2. Is any tangible property paid in for stock carried as an asset by the corporation? [illegible] In excess of the par value of the stock paid therefor? [illegible] Act of 1921. Enter this amount at Item 2, Schedule G, for the taxable period.

G3. Was the business reincorporated, reorganized, or consolidated or was its ownership changed or was there a change in ownership of property after March 3, 1917? [illegible] If so, answer the following questions:

a. Did an interest of [illegible] per cent or more in the business or in the property which changed ownership remain in the control of the same persons, corporations, associations, or partnerships or of any of them? [illegible]

b. Were any of the assets entered on the books of the corporation making this return at a higher value than on the books of its predecessor? [illegible]

c. If such previous owner was not a corporation, attach a statement showing (1) the cost of acquisition to the previous owner of any asset so transferred [illegible] expenditures subsequent to that date for betterment or development not deducted as expense or otherwise since March 1, 1913, by such previous owner [illegible] the allowance for depreciation, depletion, or impairment since the date of acquisition by such previous owner.

d. If all, or substantially all of the property was acquired from a corporation during the taxable period, attach hereto balance sheets of such predecessor corporations as at the beginning of the taxable period and as at the date immediately prior to the transfer of the property to the corporation making the return, and also a balance sheet or statement of the corporation making this return showing the values at which such property received or transferred were entered on the books.

For the purpose of determining invested capital each asset so transferred shall be allowed a value (a) not greater than would have been allowed to the previous owner, if a corporation, or, (b) if not a corporation, at its cost to such previous owner, with proper adjustments for losses and improvements.

G4. [illegible] amount of cash paid therefor [illegible]

G5. [illegible]

G6. [illegible]

Item	Amount
1. [illegible]	
2. [illegible]	
3. [illegible]	
4. [illegible]	
5. [illegible]	
6. [illegible]	
7. [illegible]	

SCHEDULE H.—CHANGES IN INVESTED CAPITAL DURING TAXABLE PERIOD.

[illegible]

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1					
2					
3					
4					
5					
6					
7					
8. Net [illegible]					

SCHEDULE J.—INADMISSIBLE ASSETS.

[illegible]

This percentage [illegible] Schedule B [illegible] deduction on account of inadmissible [illegible] Schedule B [illegible]

QUESTIONS.

KIND OF BUSINESS.

1. By means of the key letters given below identify the corporation's main income-producing activity with one of the general classes and follow this by a special description of the business sufficient to give the information called for under each general class. A.—Agriculture and related industries including fishing, logging, ice harvesting, etc., and also the leasing of such property to the product or products. B.—Mining and quarrying, including gas and oil wells, and also the leasing of such property. State the product or products. C.—Manufacturing. State the product and also the material if not implied by the name of the product. D.—Construction—excavations, buildings, bridges, railroads, ships, etc., also equipping and installing same with systems, devices, or machinery, without their manufacture. State nature of structures built, materials used, or kind of installations. E1.—Transportation—rail, water, local, etc. State the kind and special product transported, if any. E2.—Public utilities—gas (natural, coal, or water), electric light or power (hydro or steam generated), heating (steam or hot water); telephone, waterworks or power. E3.—Storage without trading or profit from sales—(elevators, warehouses, stockyards, etc.). State product stored. E4.—Leasing transportation or utilities. State kind of property. F.—Trading in goods bought and not produced by the trading concern. State manner of trade, whether wholesale, retail, or commission, and product handled. Sales with storage with profit primarily from sales. G.—Service—domestic, including hotels, restaurants, etc.; amusements; other professional, personal, or technical service. State the service. H.—Finance, including banking, real estate, insurance. I.—Concerns not falling in above classes (a) because of combining several of them with no predominant business, or (b) for other reasons.

2. Concerns whose business involves activity falling in two or more of the above general classes, where the *same product* is concerned, should report business as identified with but one of the above general classes; for example, concerns in A or B which also transport and market their own product exclusively or mainly, should still be identified with classes A or B; concerns in C (manufacturing) which own or control their source of material supply in A or B and which also transport, sell, or install their own product exclusively or mainly, should be identified with manufacturing; concerns in D may control or own source of supply of materials used exclusively or mainly in their construction work; concerns in E1 or E2 may own or control the source of their material or power; concerns in F may transport or store their own merchandise, but its production would identify them with A, B, or C.

3. Answers:

(a) General class (use key letter designation) ....

(b) Main income-producing business (give specifically the information called for under each key letter, also whether acting as principal, or as agent on commission; state if inactive or in liquidation ....

....

....

....

OTHER CORPORATIONS IN SAME BUSINESS.

4. Enter on the following lines the names and addresses of five representative corporations in your locality or section of the country engaged in the same kind of business.

....

....

....

....

....

INCORPORATION.

5. Date of incorporation ....

6. Under the laws of what State or country ....

REORGANIZATION AND ACQUISITION OF MIXED AGGREGATES OF ASSETS.

7. Has the corporation, *or any of its predecessors*, been reorganized, or has it, *or any of its predecessors*, taken over a going business or acquired a mixed aggregate of tangible and intangible property, and paid for such property in whole or in part with stock or other securities since the close of the preceding taxable period? ....

8. If so, furnish a brief narrative history of the business and submit a statement showing:

(a) The name of the concern taken over (or from which the property was acquired).
(b) The nature of the assets and liabilities so acquired.
(c) The total par value of the stock issued therefor.
(d) The value at which each class of assets was carried on the books of the concern from which acquired (submit a balance sheet of the predecessor concern as at the date of acquisition or as at the close of its last accounting period prior thereto);
(e) The value at which each item was carried on the books of the corporation making this return, and full details of any adjustments subsequently made pertaining thereto and the basis on which such revaluation was made.

9. If patents, copyrights, secret processes or formulæ, good will, trade-marks, trade brands, franchises, or other intangible property were acquired, state the basis on which their value was determined and how they were paid for.

10. If at the time of any purchase or reorganization as contemplated in question 7, any property was entered on the books of the reorganized concern or any vendee predecessor at a value in excess of that at which it was carried on the books of the vendor concern, state the basis on which the revaluation was made.

AFFILIATIONS WITH OTHER CORPORATIONS (TO BE ANSWERED BY EVERY CORPORATION).

11. Does the corporation own directly or control through closely affiliated interests or by a nominee or nominees over 70 per cent of the outstanding voting capital stock of another corporation or of other corporations? ....

12. Is over 70 per cent of your outstanding voting capital stock owned by another corporation or by two or more corporations that are affiliated? ....

13. Is over 70 per cent of your outstanding voting capital stock as well as over 70 per cent of the outstanding voting capital stock of another corporation or of other corporations owned or controlled by the same individual or partnership or by the same individuals or partnerships? ....

14. If the answer to questions 11, 12, and 13, or to any of them is "yes," answer the following:

(a) Did the corporation file Affiliated Corporations Questionnaire, Form 819, for 1917 or subsequent taxable years? .... If the answer to this question is "yes," a questionnaire is not required, except under the circumstances described in question (b). If the answer to this question is "no," and the answer to questions 11, 12, and 13, or to any of them, is "yes," procure from the Collector of Internal Revenue for your district Form 819, which shall be filled out and filed as a part of this return. If the answer to this question is "no," question (b) need not be answered.

(b) Did substantially the same conditions, as are set out in the questionnaire filed for 1920 or prior years, obtain during the entire taxable period 1921? .... If the answer to this question is "no" a statement, setting forth the particulars in which the situation has changed should be attached to and made a part of this return. If there have been substantial changes in stockholdings, a complete schedule of such changes should be submitted in the form prescribed in Tables 3 and 6 of the questionnaire. If there are companies other than those covered by the questionnaire for 1920 or prior years which, applying the tests contained in questions 11, 12, or 13, may have come into the affiliated group since 1920, a questionnaire, Form 819, is required for the entire group for the taxable period.

VALUATION OF CAPITAL STOCK.

15. What was the fair value of the total capital stock of the corporation as determined in the last assessment, if any, of the capital stock tax? $.................. Date of that assessment ....

PREDECESSOR BUSINESS.

16. Did the corporation file a return under the same name for the preceding taxable period? .... If not, was the corporation in any way an outgrowth, result, continuation, or reorganization of a business or businesses in existence during the preceding taxable period? .... If answer is "yes," give name and address of each predecessor business.

....

....

BASIS OF RETURN.

17. Is this return made on the basis of actual receipts and disbursements? ....

If not, describe fully what other basis or method was used in computing net income ....

....

....

GOVERNMENT CONTRACTS.

18. Have any adjustments been made during the taxable period on account of contract or contracts with the Government or its agencies or in any Government contract or contracts from which the corporation derived income directly or indirectly, through the operations of a claim board or otherwise? .... If the answer to this question is "yes," state the amounts involved? ....; whether or not such amounts are included in this return ....; and, if not, was an amended return, accounting for the additional income, filed for the taxable period in which the contract was terminated? .... Submit a schedule showing full particulars of the contract, date entered into, date the work ceased under said contract or contracts, and the amount and nature of the adjustment.

AMORTIZATION.

19. Has amortization been claimed? .... If the answer to this question is "yes," state for what year .... Amount $..................

LIST OF ATTACHED SCHEDULES.

Enter below a list of all schedules accompanying this return, giving for each a brief title and the schedule number.

....

....

....

....

....

....

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....

....

SCHEDULE K.—BALANCE SHEETS.

Attach hereto balance sheets as at the beginning and end of the taxable period (preferably in parallel columns), showing as nearly as practicable the details called for below. (These balance sheets should be prepared from the books and should be in agreement therewith, or any differences should be reconciled, and if this is a consolidated return, balance sheets should be furnished in accordance with paragraph 7 on page 1 of Instructions.)

ASSETS.

Cash (including cash items and on hand, certificates of deposit, etc.).
Trade accounts (before deducting reserves for losses).
Notes receivable from customers.
Other accounts and notes receivable (to be classified).
Inventories:
- Raw materials.
- Work in progress.
- Finished products.
- Supplies.

Investments:
- Bonds:
  - U. S. bonds and obligations (each issue to be stated separately).
  - Exempt (municipal, State, etc.).
  - Other.

ASSETS—Continued.

Investments—continued.
- Stock of corporations—
  - Foreign.
  - Domestic.

Loans and advances:
- To officers and employees.
- To others.

Deferred charges to future operations (to be detailed).
Fixed assets:
- Land.
- Buildings.
- Machinery.
- Tool and minor equipment.
- Delivery equipment.
- Office furniture.
- Other (state character).

ASSETS—Continued.

Fixed assets—continued.
- Less reserves for depreciation (show separately amount applicable to each fixed asset).*

NET VALUE.

Patents, good will, and other intangible assets:
- Paid for in cash or other tangible property.
- Paid for in stock (other than stock dividends).
- Created by stock dividend or otherwise.

Discount:
- On bonds.
- On stock.

TOTAL.

LIABILITIES.

Notes payable:
- To officers and stockholders.
- To others (including bank loans).

Accounts payable:
- Trade.
- Other.

Accrued expenses and reserves, the charges creating which are allowable deductions from income (to be detailed).
Reserves, the charges creating which are not allowable deductions from income:
- Reserves for losses on notes and accounts receivable.
- Other reserves (to be detailed).

Capital stock outstanding (to be classified).
Surplus and undivided profits.

TOTAL.

*Reserves for depreciation may be deducted from the respective asset accounts or itemized on the liability side of the balance sheet.

All corporations engaged in an interstate and intrastate trade or business and reporting to the Interstate Commerce Commission and to any national, State, municipal, or other public officer, may submit in lieu of above form, copies of their balance sheets prescribed by said Commission or State and municipal authorities, as at the beginning and end of the taxable period.

2—10476

SCHEDULE L.—RECONCILIATION OF NET INCOME AND ANALYSIS OF CHANGES IN SURPLUS.

1. Net income from Schedule A, Item 27 .... $
2. Nontaxable income:
   - (a) Interest on obligations of the United States and its possessions exempt ....
   - (b) Interest on obligations of States, territories, and political subdivisions thereof ....
   - (c) Interest on Farm Loan Bonds issued under Federal Farm Loan Act ....
   - (d) Dividends from [illegible] Section 234 (a) 6 of the Revenue Act of 1921 ....
   - (e) Dividends on stock of personal service corporations out of earnings upon which a Federal income tax has been imposed ....
   - (f) Other items of nontaxable income (to be detailed):
     - (1) ....
     - (2) ....
     - (3) ....
3. Charges against reserves for bad debts, if Item 17, Schedule A, is not an addition to a reserve ....
4. Charges against reserves for contingencies, etc. (to be detailed):
   - (a) ....
   - (b) ....
   - (c) ....
5. Total of Items 1 to 4, inclusive .... $
6. Total from Item 14 ....
7. Net profit for year as shown by books, before any adjustments are made therein (Item 5 minus Item 6) .... $
8. Surplus and undivided profits as shown by balance sheet at close of preceding taxable period ....
9. Other credits to surplus (to be detailed):
   - (a) ....
   - (b) ....
   - (c) ....
10. Total of Items 7 to 9, inclusive .... $
11. Total from Item 17 ....
12. Surplus and undivided profits as shown by balance sheet at close of taxable period (Item 10 minus Item 11) .... $
13. Unallowable deductions:
    - (a) Donations, gratuities, and contributions .... $
    - (b) Income and profits taxes paid to the United States, its possessions, or foreign countries ....
    - (c) Special improvements of taxes tending to increase the value of the property assessed ....
    - (d) Furniture and fixtures, additions, or betterments treated as expenses on the books ....
    - (e) Replacements and renewals ....
    - (f) Insurance premiums paid on the life of any officer or employee where the corporation is directly or indirectly a beneficiary ....
    - (g) Interest on indebtedness incurred or continued to purchase or carry obligations or securities of the United States the interest upon which is wholly exempt from taxation except interest incurred to purchase or carry Victory 3¾% Notes originally subscribed for by the taxpayer ....
    - (h) Additions to reserves for bad debts which are not included in Item 17, Schedule A ....
    - (i) Additions to sinking fund reserve and reserves for bad debts and other contingencies (to be detailed):
      - (1) ....
      - (2) ....
      - (3) ....
    - (j) Other unallowable deductions (to be detailed):
      - (1) ....
      - (2) ....
      - (3) ....
14. Total of Item 13 .... $
15. Dividends paid during the taxable period (state whether paid in cash, stock of the company, or other property):
    - (a) Date paid .... Character .... $
    - (b) Date paid .... Character ....
    - (c) Date paid .... Character ....
    - (d) Date paid .... Character ....
16. Other debits to surplus (to be detailed):
    - (a) ....
    - (b) ....
    - (c) ....
17. Total of Items 15 and 16 .... $

SCHEDULES TO BE FURNISHED IN SUPPORT OF ITEMS IN SCHEDULE A.

The following schedules must be furnished, and those prepared on separate sheets should be firmly attached to this return. Enter name and address of corporation on each sheet.

SCHEDULE A2: COST OF GOODS SOLD, EXCLUSIVE OF ITEMS CALLED FOR SEPARATELY.

If engaged in a trade or business in which the production, purchase, or sale of merchandise of any kind is an income-producing factor (a) secure from the Collector of Internal Revenue and file as a part of this return, Certificate of Inventory, Form 1126, and (b) fill in the following schedule entering on lines 3 and 5 immediately before the amount column, the letters "C," or "C or M" to indicate that inventories are valued at either cost, or cost or market, whichever is lower.

(1) Merchandise bought for sale .... $
(2) Cost of manufacturing or otherwise producing goods (Submit schedule showing principal items of cost, the minor items being grouped in one amount) ....
(3) Plus inventory at beginning of year ....
(4) Total .... $
(5) Less inventory at end of year ....
(6) Cost of goods sold .... $

SCHEDULE A3: GROSS INCOME FROM OPERATIONS OTHER THAN TRADING OR MANUFACTURING.

Submit a schedule showing the nature and amount of the principal items included herein, the minor items being grouped in one amount. (For insurance companies see page 2 of Instructions, paragraphs 2 and 7.)

SCHEDULE A4: TAXABLE INTEREST ON LIBERTY BONDS, ETC.

The interest on the obligations listed in column 1 of the following table is wholly exempt from corporation income tax, and is exempt from excess-profits tax only to the extent that the aggregate principal amounts do not exceed the exemptions specified in columns 2, 3, and 4.

In case the obligations held exceed these exemptions, the principal amounts in excess thereof should be entered in column 5 and the taxable interest thereon in column 6. If these securities were bought and sold during the taxable period, attach a statement showing the holdings by periods.

If this is a consolidated return, each corporation composing the affiliated group is entitled to the full amount of these exemptions.

1 Obligations.	Exemptions (Aggregate Principal Amount)			5 Principal amount in excess of exemptions specified in columns 2, 3, and 4	6 Interest on principal amount in excess of exemptions.
	2 $50,000	3 $125,000	4 $5,000		
(a) First Liberty Loan Second Converted 4¼% Bonds					
(b) First and Second 4's, and First, Second, Third, and Fourth 4¼'s	None				
(c) Other obligations issued since September 1, 1917 (except Victory and Treasury Notes)	None	None			
(d) Victory Liberty Loan 4¾% Notes, and Treasury Notes	None	None	None		
Total Taxable Interest					$

SCHEDULE A10: GROSS INCOME FROM ALL OTHER SOURCES (not including any amount with respect to sale of capital assets or miscellaneous investments).

Submit a schedule showing the source, nature, and amount of the principal items included herein, the minor items being grouped in one amount. The total of the schedule should be entered as Item 10, Schedule A.

SCHEDULE A12: EXPENSES (except amounts called for separately in Schedule A).

Submit a statement showing character and amount of the principal items included herein, the minor items being grouped in one amount. (For schedules to be submitted by insurance companies see page 2 of Instructions, paragraphs 3 to 7.)

SCHEDULE A13: COMPENSATION OF OFFICERS.

Submit a schedule showing for each officer (1) name, (2) duties, (3) time devoted to such duties, (4) shares of stock owned or controlled (a) preferred, (b) common, (5) total compensation for the taxable period, and (6) amount of, and reason for increase (if any), over preceding period.

SCHEDULE A14: REPAIRS (including labor, supplies, overhead, and other items properly chargeable to repairs).

Submit a schedule showing the nature and amount of the principal items included herein, the minor items being grouped in one amount. (For classification of repairs see page 2 of Instructions, paragraph 8.)

SCHEDULE A16: TAXES.

Submit a schedule showing separately for each class of taxes deducted, (a) character and (b) amount.

Federal income and profits taxes, taxes which are a credit under Section 238, taxes assessed against local benefits of a kind tending to increase the value of the property assessed are not allowable deductions. (See Section 234(a) 3 of the Revenue Act of 1921.)

SCHEDULE A17: BAD DEBTS.

Submit a schedule showing debts or portions thereof arising from sales or professional services that have been reported as income, which have been definitely ascertained to be worthless and charged off within the year, or such reasonable amount as has been added to a reserve for bad debts within the year.

If the amount entered as Item 17, Schedule A, is an addition to a reserve, furnish proof of the reasonableness of the amount. (See Section 234(a) 5 of the Revenue Act of 1921.)

SCHEDULE A19: EXHAUSTION, WEAR AND TEAR (including obsolescence).

If a deduction is made on account of depreciation, the following schedule must be filled in and the total amount claimed therein should correspond with the figures reflected in the balance sheet. Land values must not be included in this schedule. (See page 2 of Instructions, paragraph 1[illegible], and Section 234 (a) 7 of the Revenue Act of 1921.)

Kind of property (If buildings, state the material of which constructed.)	Date acquired	Age when acquired	Probable life after acquirement	Cost or if acquired prior to March 1, 1913, the fair market value on that date	Amount of depreciation charged off.	
					This year	Previous years.
				$	$	
Total				$	$	$

NOTE.—If obsolescence is a factor in determining your deduction, attach a statement showing the amount claimed for the taxable period and the basis on which computed.

SCHEDULE A19. DEPLETION.

If a deduction is claimed on account of depletion secure from the collector Form D (minerals), Form F (coal), Form F [illegible] (oil and gas), or Form T (timber), fill in and file with return. If complete valuation data has been filed with questionnaire in previous years, then file with this return information necessary to bring [illegible] schedule up to date setting forth a full statement of all transactions bearing on deduction [illegible] of the valuation of natural assets with explanation of how depletion deduction for taxable period has been determined. In case of timber this should be done by filing in Form T (timber).

SCHEDULE A20: AMORTIZATION OF WAR FACILITIES.

In case a deduction is claimed on account of amortization a schedule should be submitted containing the information called for in Guide Form 1007M which explains in detail the manner in which a claim of this nature should be presented. A copy of this form may be obtained from the Commissioner. (See Section 214 (a) 9 of the Revenue Act of 1921.)

SCHEDULE A21: PROFIT OR LOSS ON SALES OF CAPITAL ASSETS AND MISCELLANEOUS INVESTMENTS.

In case of the sale of property resulting in a profit or loss a schedule in the following form must be furnished under separate heading for each asset. (See Sections 202, 203 (a) and 234 (a) 4 of the Revenue Act of 1921.)

1 Kind of property	2 Date acquired	3 Sale price	4 Cost	5 Fair market value as of March 1, 1913 if acquired prior to that date	6 Cost of subsequent improvements	7 Depreciation.	8 Net profit (or loss.)
			$	$	$	$	$
Total							$

State what amount, if any, included in column 5, represents good will ... $ ....

If any of the assets were acquired prior to March 1, 1913, state how the fair market value on that date was determined ....

In case of exchange of property, submit evidence substantiating the basis used in arriving at the market value of property received ....

SCHEDULE A22: LOSSES BY FIRE, STORM, ETC.

A schedule similar to the one requested above should be submitted with respect to losses of property arising from fires, storms, shipwreck, or other casualty, or from theft, and not compensated for by insurance or otherwise, except that column 3 should show "Insurance and salvage" instead of "Sale price."

SCHEDULE A26: DIVIDENDS (deductible under Section 234 (a) 6 of the Revenue Act of 1921).

Submit a schedule showing the amount received as dividends (a) from each domestic corporation other than a corporation entitled to the benefits of Section 262 of the Act, or (b) from each foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under Section 217 of the Act.

DISCOUNT AND PREMIUM ON BONDS SOLD.

There must be attached to the return a schedule showing in detail each issue and sale of bonds of the reporting corporation giving the following information: (a) Class, (b) date of sale, (c) maturity, (d) amount sold; (e) amount realized, (f) premium or discount per annum.

That proportion of the premium or discount applicable to the return period must be reported either as Item 10 or 15, Schedule A, page 1, unless the amount of premiums or discount has been reported as income or allowed as a deduction in prior years.

We, the undersigned, president and treasurer of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under authority thereof.

Sworn to and subscribed before me this .... day of ...., 1922.

Seal of officer making affidavit.

.... President.

.... Treasurer.

.... (Official capacity.)

9—10670

INSTRUCTIONS FOR CORPORATION RETURN.

LIABILITY FOR FILING RETURNS.

1. **Corporations generally.**—Every domestic or resident corporation, joint-stock company, association, or insurance company not specifically exempted by Section 231 of the Revenue Act of 1921, whether or not having any net income, must file a return.

2. A corporation, having a net income of less than $3,000 for the taxable period need not fill in the schedules pertaining to excess profits tax, but if the net income is $3,000 or more, it is subject to the excess profits tax and must file a complete return on this form.

3. **Government Contracts.**—In addition thereto, if net income in excess of $10,000 was derived during the taxable period from a Government contract, Form 1120S should be secured from the Collector of Internal Revenue for your district and filed as a part of this return.

4. **Corporations in Possessions of the United States.**—Domestic corporations within the possessions of the United States (except the Virgin Islands) may report as gross income only gross income from sources within the United States, provided, (*a*) 80 per cent or more of the total gross income for the three-year period immediately preceding the close of the taxable year (or such part thereof as may be applicable) was derived from sources within a possession of the United States, and (*b*) 50 per cent or more of the total gross income for such three-year period or applicable part thereof was derived from the active conduct of a trade or business within a possession of the United States.

However, a corporation entitled to the above benefits is not entitled to the specific exemption of $3,000 in computing the excess profits tax. (See Sections 262 and 312, Revenue Act of 1921.)

5. **Foreign Corporations.**—A foreign corporation subject to the law, regardless of the amount of its net income, is required to file a return with the Collector in whose district is located its principal office or agency through which is transacted the business in the United States. If it has no office or agency in the United States, the return should be filed with the Collector of Internal Revenue, Baltimore, Maryland. The net income should be computed in accordance with Section 217 of the Revenue Act of 1921.

6. **Personal Service Corporations.**—Personal service corporations must file a return on Form 1065.

CONSOLIDATED RETURNS.

7. The parent or principal reporting company of affiliated corporations as defined in Section 240 of the Act must file a consolidated return on this form with the collector of the district in which its principal office is located and attach thereto a schedule showing the names and addresses of all affiliated corporations in the group, and if the tax is apportioned among these corporations, the amount allocated to each. (See paragraph 9, below.) Each of the other affiliated corporations shall file Form 1122 in the office of the Collector of its district.

Consolidated invested capital must be computed as at the beginning of the taxable period of the parent or principal reporting company and consolidated income must be computed on the basis of its taxable period.

All supplementary and supporting schedules should be prepared in columnar form, one column being provided for each corporation included in the consolidation, one column for a total of like items before adjustments are made, one column for intercompany eliminations and adjustments, and one column for a total of like items after giving effect to the eliminations and adjustments. The items included in the column for eliminations and adjustments should be symbolized so as to readily identify contra items affected, and if necessary, in order to give a correct understanding of these entries, suitable explanations should be appended.

8. If one domestic corporation owns 95 per cent or more of the outstanding voting stock of another, or if 95 per cent or more of the outstanding voting stock of two or more domestic corporations is owned by the same individual or individuals, partnership or partnerships, in substantially the same proportion, a consolidated return must be filed by such corporations, except that the purpose of the statute being to prevent the avoidance or reduction of tax liability, corporations engaged in entirely distinct and unrelated lines of business, there being no common dealings between them giving rise to opportunity to avoid or reduce tax liability, shall not be required to file a consolidated return. If the ownership is less than 95 per cent of the outstanding voting stock, but exceeds 70 per cent, the parent or principal corporation of any group of affiliated corporations must furnish the information called for in questions 11 to 14, page 3.

9. The Department prefers that the entire tax shown on a consolidated return be paid by the parent or principal reporting corporation, instead of being apportioned among the corporations composing the affiliated group.

If apportionment is made, each subsidiary or affiliated corporation should state on its Form 1122 the amount of income and profits taxes to be assessed against it for the taxable period.

PERIOD COVERED.

10. The taxable period is the calendar year or the fiscal period ended in such calendar year, and the net income shall be computed upon the basis of the corporation's annual accounting period (calendar year or fiscal period) in accordance with the method of keeping the books, unless such method does not clearly reflect the income. The accounting period established for the taxable year immediately preceding must be adhered to unless permission has been received from the Commissioner to make a change.

In the case of a return for a period of less than one year, the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

If the period for which the first or final return is made include fractions of months, there shall be added to the number of complete months as many thirtieths of a month as there are days in the fractional parts of months.

11. If a corporation changes its accounting period, it shall as soon as possible give to the Collector for transmission to the Commissioner written notice of such change and of its reasons therefor. Upon approval by the Commissioner, the corporation shall thereafter make its returns upon the basis of the new accounting period. See Sections 212(*c*) and 226, Revenue Act of 1921.

TIME AND PLACE FOR FILING.

12. The return must be sent to the Collector of Internal Revenue for the district in which the corporation's principal office is located, so as to reach the Collector's office on or before the fifteenth day of the third month following the close of the taxable period. In the case of a foreign corporation not having any office or place of business in the United States the return shall be filed on or before the fifteenth day of the sixth month following the close of the taxable period.

13. The Collector is authorized to grant an extension of not more than thirty days for filing returns in cases of *absence or sickness*. In meritorious cases the Commissioner is authorized to grant a further extension.

SIGNATURES AND VERIFICATION.

14. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. The return of a foreign corporation having an agent in the United States shall be sworn to by such agent. If receivers, trustees in bankruptcy, or assignees are operating the property or business of the corporation, such receivers, trustees, or assignees shall execute the return for such corporation, under oath.

PAYMENT OF TAXES.

15. The tax should be paid by sending or bringing with the return a check or money order drawn to the order of "Collector of Internal Revenue at (insert name of city and State)."

16. Do not send cash through the mail or pay it in person except at the office of the Collector.

17. The total tax may be paid at the time of filing the return or in four equal installments, as follows:

The first installment shall be paid at the time fixed by law for filing the return, the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month after the time fixed by law for filing the return.

PENALTIES.

For Making False or Fraudulent Return.

18. Not exceeding $10,000 or not exceeding one year's imprisonment, or both, in the discretion of the court, and, in addition, 50 per centum of the total tax evaded.

For Failing to Make Return on Time.

19. Not more than $1,000, and, in addition, 25 per centum of the total amount of the tax.

For Failing to Pay Tax When Due or Understatement of Tax, Through Negligence, Etc.

20. Five per centum of the tax due but unpaid plus interest at the rate of 1 per centum per month during the period in which it remains unpaid.

WORKING PAPERS.

21. Every corporation should preserve, available for inspection by a revenue officer, working papers showing—

(*a*) The balance in each account on the corporation's books that was used in preparing Schedule A.

(*b*) The amount deducted from each such balance on account of each class of nontaxable income, unallowable deductions, and other adjustments indicated in Schedule L, with a reference to the number of the item in Schedule L in which each amount so deducted was included.

(*c*) The remainder of each such balance, analyzed to show the amount included in each item of Schedule A, with a reference to the number of the item in Schedule A in which each such amount was included.

INFORMATION AT THE SOURCE.

22. Every corporation making payments of salaries, wages, interest, rent, commissions, or other fixed or determinable income of $1,000 or more during the calendar year, to any individual or partnership, is required to make a true and accurate return to the Commissioner of Internal Revenue, showing the nature of such payments and the name and address of the recipient. Forms 1096 and 1099, for reporting such information, will be furnished by any collector of internal revenue. Such returns of information covering the calendar year 1921 must be forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., in time to be received not later than March 15, 1922. 3—10474

INSTRUCTIONS REGARDING INCOME, CREDITS, COMPUTATION OF TAX, ETC.

GROSS INCOME AND DEDUCTIONS.

1 **Railroad** corporations, banks, insurance companies, and other corporations required to submit statements of income and expenses to any national, State, municipal, or other public officer may submit instead of Schedule A a statement of income and expenses in the form in which submitted to such officer. In such cases the taxable net income will be reconciled by means of Schedule L with the net profit shown by the income and expense statement submitted, and should be entered as Item 27, Schedule A, page 1.

2 A life insurance company issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), as defined by Section 242 of the Revenue Act of 1921, shall file its tax return on Form 1120L, instead of Form 1120

3 An insurance company (other than a company taxed under Section 243 of the Act) issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life, and not subject to cancellation, should file its return on this form and report as a deduction in Schedule A12 subject to the approval of the Commissioner, such portion of the net addition (not required by law) made within the taxable period to reserve funds as may be required for the protection of the holders of such policies only.

4 An insurance company (other than a life insurance company) should report as a deduction in Schedule A12 of this form, (a) the net addition required by law to be made within the taxable period to reserve funds (including in the case of an assessment insurance company the actual deposit of same with State or Territorial officers pursuant to law as additions to guarantee or reserve funds) and (b) the sums other than dividends paid within the taxable period on policy and annuity contracts.

5 A mutual marine insurance company should report as Item 3, Schedule A, of this form, the gross premiums collected and received, less amounts paid for reinsurance, and report as a deduction in Schedule A12 amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between ascertainment and the payment thereof.

6 The receipts of a shipowners' mutual protection and indemnity association, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or member, are exempt from taxation, but such association shall be subject as a corporation to the tax upon its net income from interest, dividends, and rents.

7 A mutual insurance company (including interinsurance and reciprocal underwriters but not including a mutual life or mutual marine insurance company) requiring its members to make premium deposits to provide for losses and expenses, should report in Schedule A12 of this form, the amount of premium deposits returned to its policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves unless otherwise allowed in Schedule A.

8. **Incidental repairs, which do not add to the value or appreciably prolong the life of** property, are deductible as expenses, Item 14, Schedule A. Expenditures for new buildings, machinery, equipment, or for permanent improvement or betterments which increase the value of the property are chargeable to capital account. Expenditures for restoring or replacing property are not deductible under this or any other item of the return. Such expenditures are chargeable to capital account or to depreciation reserve, depending on the treatment of depreciation on the books of the taxpayer.

9 The amount of interest deductible in Item 15, Schedule A, is the amount of interest paid within the taxable period on the corporation's indebtedness except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the corporation) the interest upon which is wholly exempt from taxation. (See Sections [illegible] and 234 [illegible] of the Revenue Act of 1921.)

10 The amount deductible on account of depreciation in Item 18, Schedule A, is an amount charged off which fairly measures the loss during the year in the value of physical property by reason of exhaustion, wear, tear, and obsolescence. Such an amount should be determined upon the basis of the cost of the property or, if acquired prior to March 1, 1913, the fair market value on that date and the probable number of years remaining of its useful life. The capital sum to be replaced should be charged off over the probable life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method is adopted must be reasonable and should be described in the return. Stocks, bonds, and like securities are not subject to exhaustion, wear and tear within the meaning of the law.

11 If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (a) its destruction in whole or in part, (b) theft or seizure, or (c) an exercise of the power of requisition or condemnation or the threat or imminence thereof, and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds expended bears to the entire proceeds. The gross receipts and deductions claimed should be included in Schedule A[illegible]. (See Section 234 [illegible] of the Revenue Act of 1921.)

CREDIT FOR INCOME AND PROFITS TAXES PAID TO FOREIGN COUNTRIES OR POSSESSIONS OF THE UNITED STATES.

12 If a credit is claimed in Item 14, Schedule D, a copy of Form 1118, completely filled out and sworn to or affirmed, must be submitted with this return. If credit is sought for taxes already paid, the form must have attached to it the receipt for each such tax payment. If credit is sought for taxes accrued, the form must have attached to it the return on which the foreign credit was based.

13 Where a credit is claimed for accrued taxes the Commissioner may, as a condition precedent to the allowance of this credit, require the corporation to give a bond (Form 1119) with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due if the taxes when paid differ from the amount claimed in respect thereof.

PROVISIONS AFFECTING COMPUTATION OF TAX.

14 Schedule D (Computation of Tax) may be subject to one or more of the following provisions:

(a) **Return for a fiscal year.**—If return is for a fiscal year ended in 1921, the tax should be computed in accordance with Sections 205, 238(c), and 335(a) of the Revenue Act of 1921

(b) **Limitation on income tax.**—If the net income reported as Item 5, Schedule D, is more than $25,000 the tax of 10 per centum imposed by Section 230 of the Act on the amount of the net income shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000

(c) **Limitations on excess profits tax.**—The maximum excess profits tax imposed shall in no case be more than 20 per cent of the net income in excess of $3,000 and not in excess of $20,000 plus 40 per cent of the net income in excess of $20,000 (Section 302), unless net income amounting to more than $10,000 was derived from a Government contract, when the tax on such income shall be assessed under Section 301(b), in which case the maximum excess and war profits tax imposed upon this proportion of the net income shall not be more than 30 per cent of the amount of net income in excess of $3,000 and not in excess of $20,000 plus 80 per cent of the amount of net income in excess of $20,000. (See Section [illegible].)

(d) **Tax of corporation whose income is derived in part from "Personal Service."**—If part of the net income (not less than 30 per cent) is derived from a separate trade or business of the character of "personal service," the tax shall be computed in accordance with the provisions of Section 303 of the Act.

(e) **Tax on corporation engaged in mining of gold.**—If a corporation is engaged in the mining of gold, its excess profits tax shall be that proportion of Item 3, Schedule D, which the net income not derived from the mining of gold bears to the total net income. (See Section 304(c) of the Act.)

(f) **Tax on profits from sale of mineral deposits.**—In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the excess profits tax attributable to such sale shall not exceed 20 per cent of the selling price of such property or interest. (See Section 337 of the Act.)

The first step is to find the excess profits tax computed without regard to this provision, the second is to find of the tax thus computed such portion as the net income from the sale bears to the total net income. If this portion equals or does not exceed 20 per cent of the selling price, then no adjustment is permitted. Should such portion exceed 20 per cent of the selling price, the tax will be that portion of the excess profits tax which the net income not attributable to the sale bears to the total net income plus 20 per cent of the selling price of the mineral deposits.

15 Statement of basis of claims.—If a corporation claims the benefit of any of the provisions enumerated in (d), (e), or (f), it should attach to the return a complete statement of the basis for such claim and a computation of the tax payable in the event that such claim is allowed. The amount of tax so computed should be entered in Schedule D.

SPECIAL CASES.

16 **Definition of special cases.**—Section 327 of the Act provides that in the following cases the tax shall be determined as provided in Section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in Section 326.

(b) In the case of a foreign corporation or a corporation entitled to the benefits of Section 262 of the Revenue Act of 1921. (See paragraph 4, page 1 of Instructions.)

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds respectively.

(d) Where upon application by the corporation the Commissioner finds and declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in Section 328. This subdivision shall not apply to any case: (1) In which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable period a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable period (computed under Section 233 of the Act) consisted of gains, profits, commissions, or other income derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

17 Treatment of special cases.—In the cases specified in Section 327 the tax shall be determined as provided under the provisions of Section 328. A corporation which comes within the provisions of subdivision (d) of Section 327 (paragraph 16 above) may make application for assessment under the provisions of Section 328, which application shall be attached to its return in the form of a statement setting forth in full: (a) The reasons why the tax should be so determined; (b) the facts upon which such reasons are based, (c) an exact description of each trade or business or important branch of a trade or business carried on by it; (d) a statement of the invested capital and net income for each year since the beginning of the prewar period; and (e) a statement showing the amount of gains, profits, commissions, or other income derived on a cost-plus basis from Government contracts made between April 6, 1917, and November 12, 1918, both dates inclusive, and showing the per cent which such income is of the total income of the corporation.

18 **Returns in special cases.**—Corporations other than foreign corporations making claim for assessment under Section 328 of the Act should answer all questions and file all schedules as far as possible and attach a statement explaining why it is impracticable to fill out the entire return.

UNDISTRIBUTED PROFITS TAXABLE TO STOCKHOLDERS.

19 If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected and paid for each taxable year upon the net income of such corporation a tax equal to fifty per centum of the amount thereof, which shall be in addition to the tax imposed by Section 230 of the Revenue Act of 1921 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax. (See Section 220, Revenue Act of 1921.)

2—10675

[illegible]

Form 1041
U. S. INTERNAL REVENUE

THIS RETURN SHOULD BE FILED NOT LATER THAN THE 15TH DAY OF THE THIRD MONTH FOLLOWING THE CLOSE OF THE ACCOUNTING PERIOD

FIDUCIARY RETURN OF INCOME

FOR CALENDAR YEAR 1921

Or for period begun ...., 1920, and ended ...., 1921

Do not write in this space
Examined by
Date received

PRINT NAMES AND ADDRESSES PLAINLY

Name and address of fiduciary ....

Name of estate or trust ....

AFFIDAVIT

I swear (or affirm) that this return, including the accompanying schedules and statements (if any), has been examined by me, and, to the best of my knowledge and belief, is a true and complete return made in good faith for the accounting period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under authority thereof.

Sworn to and subscribed before me this .... day of ...., 1922 .... [illegible]

[illegible] (Title) .... [illegible]

1. Was a return of income for 1920 filed on behalf of the estate or trust named above? ....

2. If so, to what collector's office was it sent (give district or city and State)? .... 3. Give date of creation of trust or decedent's death ....

See Instruction Number	Explain in Schedule page 2	Item Number	INCOME		
		1.	Interest on Bank Deposits, Notes, Mortgages, and Corporation Bonds	$	
14		2.	Income from Partnerships, Fiduciaries, etc. (State name and address of partnerships, etc.)		
15	A	3.	Rents and Royalties		
16	B	4.	Profit (or loss) from Business or Profession (not including income from partnerships)		
17	C	5.	Profit (or loss) from Sale of Real Estate		
18	D	6.	Profit (or loss) from Sale of Stocks, Bonds, etc.		
		7.	Dividends on Stock of Domestic Corporations		
19		8.	Other Income (including dividends received on stock of foreign corporations) (State nature of income)		
			Do not include any interest on Liberty Bonds, etc.		
		9.	TOTAL INCOME IN ITEMS 1 TO 8 (less losses shown therein, if any)		$
			DEDUCTIONS		
20		10.	Interest Paid (not including interest deducted above)	$	
21		11.	Taxes Paid (not including taxes deducted above)		
22	E	12.	Losses by Fire, Storm, etc.		
23	F	13.	Contributions		
24	F	14.	Bad Debts (not including bad debts deducted above)		
25	F	15.	Other Deductions Authorized by Law		
		16.	TOTAL OF ITEMS 10 TO 15		
		17.	NET INCOME (Item 9 minus Item 16)		$

BENEFICIARIES' SHARES OF INCOME AND CREDITS

18. Enter below the share of net income (whether distributed or not) of each beneficiary of the estate or trust (except interest on obligations of the United States), each beneficiary's share of tax paid by the debtor corporation on tax-free covenant bonds, and the income and profits taxes paid by the estate or trust to a foreign country or to a possession of the United States [illegible].
If the distributable beneficial interest in the net income is determined on a basis other than a percentage basis, attach an explanatory statement.

1. NAME AND ADDRESS OF EACH BENEFICIARY [illegible]	2. PERCENTAGE OF TOTAL INTEREST	3. DIVIDENDS (ITEM 7 ABOVE)	4. OTHER INCOME (ITEM 17 MINUS ITEM 7)	5. TAX PAID AT SOURCE ON TAX-FREE COVENANT BONDS	6. INCOME AND PROFITS TAXES PAID TO A FOREIGN COUNTRY OR TO A POSSESSION OF THE UNITED STATES
(a)		$	$	$	
(b)					
(c)					
(d)					
(e)					
(f)					
(g)					
(h)					
(i)					
(j)					
(k) TOTALS		$	$	$	$

SCHEDULE A.—EXPLANATION OF ITEM 3. (Rents and Royalties.) See Instruction 14

1. Kind of Property	2. Cost, or March 1, 1913, Value	3. Amount Received	4. Repairs	5. Depreciation and Depletion	6. Other Expenses	7. Net Profit (or Loss)
	$	$	$	$	$	$

State estimated life of property and how you figured depreciation

SCHEDULE B.—EXPLANATION OF ITEM 4. (Business or Profession.) See Instruction 16

1. Total income from business (state kind of business) $

Cost of Goods Sold		Other Business Deductions	
2. Labor	$	10. Salaries and wages not reported as "Labor" on line 2	$
3. Material and supplies		11. Rent on business property in which estate or trust has no equity	
4. Merchandise bought for sale		12. Interest on business indebtedness to others	
5. Other costs (list principal items and amounts below or on separate sheet)		13. Taxes on business and business property	
6. Plus inventory at beginning of year		14. Repairs, wear and tear, obsolescence, depletion, and property losses (explain below)	
7. Total	$	15. Amortization of war facilities	
8. Less inventory at end of year		16. Bad debts arising from sales, if already reported as income	
9. Net Cost of Goods Sold	$	17. Other expenses (list principal items and amounts below or on separate sheet)	
		18. Total (Items 10 to 17 inclusive)	$

19. Net Cost plus Total Deductions (Item 9 plus Item 18) $

20. Net Profit (or Loss) from Business (Item 1 minus Item 19) $

Explanation of deductions

SCHEDULE C.—EXPLANATION OF ITEM 5. (Sale of Real Estate.) See Instruction 17

1. Kind of Property	2. Date Acquired	3. Amount Received	4. Cost	5. March 1, 1913, Value	6. Subsequent Improvements	7. Depreciation	8. Net Profit (or Loss)
		$	$	$	$	$	$

If not acquired by purchase, state how acquired

SCHEDULE D.—EXPLANATION OF ITEM 6. (Sale of Stocks, Bonds, etc.) See instruction 18

1. Kind of Property	2. Date Acquired	3. Cost	4. March 1, 1913, Value	5. Amount Received	6. Net Profit (or Loss)
		$	$	$	$

If not acquired by purchase, state how acquired

SCHEDULE E.—EXPLANATION OF ITEM 12. (Losses by Fire, Storm, etc.) See Instruction 22

1. Kind of Property	2. Cost or March 1, 1913, Value	3. Depreciation Previously Taken	4. Salvage Value	5. Insurance	6. Net Loss
	$	$	$	$	$

SCHEDULE F.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 13, 14, AND 15.

An amended return must be plainly marked "Amended" across the face of the return.

3—1170

Form 1041
U S Internal Revenue

FIDUCIARY RETURN OF INCOME

FOR CALENDAR YEAR 1921

DUPLICATE

DUPLICATE

Or for period begun ...., 1920, and ended ...., 1921

PRINT NAMES AND ADDRESSES PLAINLY

DETACH AND RETAIN THIS COPY AND THE INSTRUCTIONS

Name and address of fiduciary ....

Name of estate or trust ....

IF YOU NEED ASSISTANCE GO TO A DEPUTY COLLECTOR OR TO THE COLLECTOR'S OFFICE

FIDUCIARY'S MEMORANDA

....

1 Was a return of income for 1920 filed on behalf of the estate or trust named above? ....

2 If so, to what collector's office was it sent (give district or city and State)? .... 3 Give date of creation of trust or decedent's death ....

See Instruction Number	Explain in Schedule (page 2)	Item Number	INCOME		
		1	Interest on Bank Deposits, Notes, Mortgages, and Corporation Bonds	$	
14		2	Income from Partnerships, Fiduciaries, etc (State name and address of partnerships, etc)		
15	A	3	Rents and Royalties		
16	B	4	Profit (or loss) from Business or Profession (not including income from partnerships)		
17	C	5	Profit (or loss) from Sale of Real Estate		
18	D	6	Profit (or loss) from Sale of Stocks, Bonds, etc		
		7	Dividends on Stock of Domestic Corporations		
19		8	Other Income (including dividends received on stock of foreign corporations) (State nature of income) (a) .... (b) .... (c) .... (Do not include any interest on Liberty Bonds, etc)		
		9	Total Income in Items 1 to 8 (less losses shown therein, if any)		$
			DEDUCTIONS		
20		10.	Interest Paid (not including interest deducted above)	$	
21		11.	Taxes Paid (not including taxes deducted above)		
22	E	12	Losses by Fire, Storm, etc		
23	F	13.	Contributions		
24	F	14.	Bad Debts (not including bad debts deducted above)		
25	F	15.	Other Deductions Authorized by Law		
		16	Total of Items 10 to 15		
		17.	Net Income (Item 9 minus Item 16)		$

BENEFICIARIES' SHARES OF INCOME AND CREDITS

18 Enter below the share of net income (whether distributed or not) of each beneficiary of the estate or trust (except interest on obligations of the United States), each beneficiary's share of tax paid by the debtor corporation on tax-free covenant bonds, and the income and profits taxes paid by the estate or trust to a foreign country or to a possession of the United States (See Instructions 6 to 9, inclusive)
If the distributable beneficial interest in the net income is determined on a basis other than a percentage basis, attach an explanatory statement

	1 Name and Address of Each Beneficiary (Designate nonresident aliens)	2 Per centage of Beneficial Interest	3 Dividends (Item 7 above)	4 Other Income (Item 17 minus Item 7)	5 Tax Paid at Source on Tax-Free Covenant Bonds	6 Income and Profits Taxes Paid to a Foreign Country or to a Possession of the United States
(a)	....		$	$	$	$
(b)	....					
(c)	....					
(d)	....					
(e)	....					
(f)	....					
(g)	....					
(h)	....					
(i)	....					
(j)	....					
(k)	Totals		$	$	$	$

3—11730

SCHEDULE A.—EXPLANATION OF ITEM 3. (Rents and Royalties.) See Instruction 15

1. Kind of Property	2. Cost, or March 1, 1913 Value	3. Amount Received	4. Repairs	5. Depreciation and Depletion	6. Other Expenses	7. Net Profit (or Loss)
	$	$	$	$	$	$

State estimated life of property and how you figured depreciation

SCHEDULE B.—EXPLANATION OF ITEM 4. (Business or Profession.) See Instruction 16

1. Total income from business (state kind of business) $

Cost of Goods Sold		Other Business Deductions:	
2. Labor	$	10. Salaries and wages not reported as "Labor" on line 2	$
3. Material and supplies		11. Rent on business property in which estate or trust has no equity	
4. Merchandise bought for sale		12. Interest on business indebtedness to others	
5. Other costs (list principal items and amounts below or on separate sheet)		13. Taxes on business and business property	
		14. Repairs, wear and tear, obsolescense, depletion, and property losses (explain below)	
6. Plus inventory at beginning of year		15. Amortization of war facilities	
		16. Bad debts arising from sales, if already reported as income	
7. Total	$	17. Other expenses (list principal items and amounts below or on separate sheet)	
8. Less inventory at end of year		18. Total (Items 10 to 17, inclusive)	$
		19. Net Cost plus Total Deductions (Item 9 plus Item 18)	$
9. Net Cost of Goods Sold	$	20. Net Profit (or Loss) from Business (Item 1 minus Item 19)	$

Explanation of deductions

SCHEDULE C.—EXPLANATION OF ITEM 5. (Sale of Real Estate.) See Instruction 17

1. Kind of Property	2. Date Acquired	3. Amount Received	4. Cost	5. March 1, 1913 Value	6. Subsequent Improvements	7. Depreciation	8. Net Profit (or Loss)
		$	$	$	$	$	$

If not acquired by purchase, state how acquired

SCHEDULE D.—EXPLANATION OF ITEM 6. (Sale of Stocks, Bonds, etc.) See Instruction 18

1. Kind of Property	2. Date Acquired	3. Cost	4. March 1, 1913, Value	5. Amount Received	6. Net Profit (or Loss)
		$	$	$	$

If not acquired by purchase, state how acquired

SCHEDULE E.—EXPLANATION OF ITEM 12. (Losses by Fire, Storm, etc.) See Instruction 22

1. Kind of Property	2. Cost, or March 1, 1913, Value	3. Depreciation Previously Taken	4. Salvage Value	5. Insurance	6. Net Loss
	$	$	$	$	$

SCHEDULE F.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 13, 14, AND 15.

An amended return must be plainly marked "Amended" across the face of the return.

INSTRUCTIONS FOR FIDUCIARY RETURN

1. RETURNS BY FIDUCIARIES.

Returns on Form 1041 for estates and trusts.—Every fiduciary, or one in case of joint fiduciaries, must make a return on this form (Form 1041) for the estate or trust for which he acts, if the income of such estate or trust is distributable periodically, or the tax is payable by the beneficiaries, provided (a) the net income of such estate or trust for the taxable year was $1,000 or over or (b) any beneficiary of such estate or trust is a nonresident alien.

Returns on Form 1040 for estates and trusts.—Income of (a) estates of decedents before final settlement, (b) trusts, whether created by will or deed, for unascertained persons or persons with contingent interests, or income held, or which under the terms of the will or trust may be held, for future distribution, is taxed to the fiduciary as a single person, except that from the income of a decedent's estate there may first be deducted any amount properly paid or credited to a beneficiary. In such cases the fiduciary should make a return for the estate or trust on Form 1040 or 1040A. (See Sections 200, 219, and 225 of the Revenue Act of 1921.)

Returns on Form 1040 for beneficiaries.—A return on Form 1040 or 1040A should be rendered by the fiduciary in the case of (a) income distributable to a nonresident alien, regardless of amount, (b) an ordinary guardianship of a minor (unless such minor himself makes a return), or committee for an insane person, if the net income for the taxable year amounted to $2,000 or over, if married and living with husband or wife on the last day of the taxable year, or if the net income for the taxable year amounted to $1,000 or over, if not married or not living with husband or wife on the last day of the taxable year or if in any case the gross income was $5,000 or over, (c) an estate of a decedent before final settlement, and (d) if part of the income of a trust estate is distributed to beneficiaries and part is retained for the benefit of the trust estate. Under the conditions described in (d), a return should be made on Form 1041 for the entire income of the trust estate, and on Form 1040 for the retained portion of the income. Any income properly paid, credited, or distributable to a beneficiary is taxable directly to the beneficiary.

Returns for decedent.—If the net income of a decedent from the beginning of the taxable year to the date of his death was $1,000, if unmarried, or $2,000, if married and living with husband or wife, or if in either case the gross income was $5,000 or over, the executor or administrator shall make a return on Form 1040 or 1040A for such decedent.

Returns for two trusts.—If two or more trusts, the income of which is taxable to the beneficiaries, were created by the same person and are in charge of the same trustee, the trustee shall make a single return on Form 1041 for all such trusts, notwithstanding that they may arise from different instruments. If, however, a trustee holds trusts created by different persons for the benefit of the same beneficiary, he shall make a return on Form 1041 for each trust separately.

2. PERIOD TO BE COVERED BY RETURN.

In general, the regulations governing the preparation of returns by fiduciaries are the same as those governing individuals.

The return must be filed for the calendar year ending December 31, 1921, or for the fiscal year ending on the last day of any month other than December. The dates on which the period covered by the return begins and ends, if other than a calendar year, must be plainly stated at the head of the return.

A fiduciary was required to file the 1918 return for an estate or trust on the basis of its annual accounting period. The period for which the return for 1918 was filed must be adhered to for subsequent years, unless permission was received from the Commissioner to make a change.

3. ACCRUED OR RECEIVED INCOME.

If the books of an estate or trust are kept on an accrual basis, report all income accrued, even though it has not been actually received or entered on the books, and expenses incurred instead of expenses paid.

If the books do not show income accrued and expenses incurred, report all income received or constructively received, such as bank interest credited to the account of the estate or trust, and expenses paid.

4. ITEMS EXEMPT FROM TAX.

The following items are exempt from Federal income tax and should not be reported, unless it is desired to establish a net loss (in which case see Section 204 of the Revenue Act of 1921).

(a) The proceeds of life insurance policies paid upon the death of the insured.

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract.

(c) Gifts (not made as a consideration for service rendered), and money and property acquired under a will or by inheritance (but the income derived from money or property received by gift, will or inheritance is taxable and must be reported).

(d) Interest upon (1) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (2) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (3) the obligations of the United States or its possessions; or (4) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit) and in the case of bonds issued by the War Finance Corporation, the [illegible] of the Revenue Act of [illegible] exempt to the taxpayer from income tax.

(e) Amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness.

(f) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war.

5. FARMER'S INCOME SCHEDULE.

If the estate or trust derives income from farming, and no books of account are kept, or books are kept on a cash basis, obtain from the Collector, and attach to this return, Form 1040F, Schedule of Farm Income and Expenses. Enter the net farm income as Item 4, page 1 of the return. If the farm books of account are kept on an accrual basis, the filing of Form 1040F is optional. Report income from rents, interest, sales of property, etc., in Items 1 to 6 of the return.

6. DISTRIBUTION OF INCOME.

The table under Item 18, page 1 of the return, is to be used for showing each beneficiary's share of the net income, whether distributed or not.

Enter on lines (a), (b), (c), etc., the distributive amount of the totals shown in columns 3 and 4 to which each beneficiary is entitled, whether distributed or not. If the amount to be entered in column 4 is a loss, the amount should be indicated by red ink or a minus sign.

7. TAX PAID AT THE SOURCE.

If the estate or trust received interest directly or through a partnership, personal service corporation, or another fiduciary, on corporation bonds containing a clause by which the debtor corporation agrees to pay the interest without any deduction for taxes and there were filed with such interest coupons a white certificate, Form 1000, not claiming exemption, a tax of 2 per cent was paid at the source, and this tax should be allocated to the beneficiaries in column 5, Item 18.

8. CREDIT FOR INCOME AND PROFITS TAXES PAID TO A FOREIGN COUNTRY OR TO A POSSESSION OF THE UNITED STATES.

If any amount is entered in column 6, Item 18, page 1 of the return, a copy of Form 1116, completely filled out and sworn to or affirmed, must be submitted with this return. If such taxes have been paid, Form 1116 must have attached to it the receipt for each such tax payment. If such taxes have been accrued, Form 1116 must have attached to it a copy of the return on which each such accrued tax was based, or other evidence as to the accrual of taxes. (See Section 222 of the Revenue Act of 1921.)

When a credit is claimed on Form 1040 or Form 1040A for accrued taxes, the Commissioner may, as a condition precedent to the allowance of such credit, require the taxpayer to give a bond on Form 1117, with sureties satisfactory to and to be approved by him, in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due if the taxes when paid differ from the amount claimed in respect thereof.

9. INTEREST ON LIBERTY BONDS, ETC.

In case the estate or trust owned Liberty Bonds or other obligations of the United States issued since September 1, 1917 (except Victory Liberty Loan 3¾% Notes and postal saving certificates of deposit), or a share of these obligations held by a partnership, personal service corporation, or another fiduciary, the fiduciary should advise each beneficiary as to his proportionate amount of these obligations and the interest thereon, in order that the beneficiary may determine whether such interest is taxable on his individual income tax return.

To determine the interest on any class of obligations received during the accounting period, where the books are kept on a cash receipts and disbursements basis, add to the amount of all coupons and registered bond interest falling due within the accounting period the amount of accrued interest received on sales of obligations between interest payment dates, and deduct from this sum the accrued interest paid on purchases of obligations between interest payment dates. This method will be followed where books are kept on a cash basis, whether or not the coupons falling due within the accounting period are actually cashed. If the books are kept on the accrual basis, report the actual amount of interest accrued on the obligations owned during the accounting period.

10. AFFIDAVIT.

The affidavit must be executed by the individual or organization receiving, or having custody or control and management of the income of the estate or trust. If two or more individuals act jointly as a fiduciary, the affidavit may be executed by any one of them.

The oath will be administered without charge by any collector, deputy collector, or internal revenue agent. If an internal revenue officer is not available, the return should be sworn to before a notary public, justice of the peace, or other person authorized to administer oaths.

It is not necessary to show the statement of net income to the officer who administers the oath.

11. WHEN AND WHERE THE RETURN MUST BE FILED.

If the return is for the calendar year 1921, file it with the Collector of Internal Revenue for the district in which the fiduciary resides or has his principal place of business, so as to reach the collector's office on or before March 15, 1922. If for a period other than a calendar year, the return should be filed on or before the 15th day of the third month following the close of such period. If the fiduciary has no legal residence or principal place of business in the United States, the return should be forwarded to the Collector of Internal Revenue, Baltimore, Md. (See Section 227 of the Revenue Act of 1921.)

12. PENALTY FOR FAILING TO MAKE RETURN ON TIME.

A penalty of not more than $1,000 attaches for failure to file the return within the time required by law. If the failure is willful or an attempt is made to defeat or evade the tax, the penalty is not more than $10,000 or imprisonment for not more than one year, or both, together with costs of prosecution.

13. INFORMATION AT THE SOURCE.

Every fiduciary who, during the calendar year 1921, paid to any individual, partnership, or personal service corporation, salaries, wages, commissions, rentals, or other fixed or determinable income of $1,000 or more, is required to make a true and accurate return to the Commissioner of Internal Revenue showing the nature and source of such payments and the name and address of the recipient. All Forms 1099 must be accompanied by Form 1096 and should be forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., in time to be received not later than March 15, 1922.

14. INCOME FROM PARTNERSHIPS, FIDUCIARIES, ETC.

Report the share of the estate or trust, whether received or not, in the profits of a partnership or personal service corporation, or in the income of another estate or trust, except the part of such share that consisted of dividends on stock of domestic corporations, which should be included in Item [illegible], page 1, of the return, and the interest on obligations of the United States (see Instruction [illegible]).

If the accounting period on the basis of which this return is filed fails to coincide with the annual accounting period of the partnership, personal service corporation, or fiduciary, then you should include in this return the distributive share of the total net income for such accounting period ending within your taxable period.

15. INCOME FROM RENTS AND ROYALTIES.

If property or crops was received in lieu of cash rent, report the income as though the rent had been received in cash. Crops received as rent on a crop share basis should be reported as income for the year in which disposed of, unless your return shows income accrued.

Explain in Schedule A, page 2, repairs, depreciation, depletion, and other expenses.

Other expenses include interest, taxes, fire insurance, fuel, light, labor, and other necessary expenses of this character.

16. INCOME FROM BUSINESS OR PROFESSION.

Report in Item 4 the net profit (or loss) from—

(a) Sale of merchandise, or of products of manufacturing, construction, mining, and agriculture.

(b) Business service, such as transportation, storage, laundering, hotel and restaurant service, livery and garage service, etc.

In general, report in Item 4 any income in the earning of which expenses for labor, rent, etc., were incurred.

If the estate or trust derives income from farming, see Instruction [illegible].

Describe the business or services rendered, as "grocery," "retail clothing," "drug store," "jobber," "importer," "broker," "farmer," etc., on line 1, Schedule B, page 2 of the return.

Enter also on line 1, Schedule B, the total income from business or sales, less any discounts or allowances from the sale price.

If engaged in a trade or business in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, secure from the Collector of Internal Revenue and file as a part of this return a *Certificate of Inventories, Form 1116*.

Salaries.—Enter on line 10 all salaries and wages not reported as "Labor" on line 2.

Rent.—Enter on line 11 rent on business property in which the estate or trust has no equity. Do not include rent for dwelling occupied by any beneficiary for residential purposes.

Interest.—Enter on line 12 interest on business indebtedness to others. Do not include interest of the estate or trust on capital invested in or advanced to the business.

Taxes.—Enter on line 13 taxes on business property or for carrying on business. Do not include taxes assessed against local benefits of a kind tending to increase the value of the property assessed, as for paving, sewers, etc., nor Federal income taxes.

Repairs, wear and tear, obsolescence, depletion, and property losses other than merchandise.—Enter on line 14 (a) ordinary repairs required to keep property in usable condition, (b) reasonable allowance for exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence, and (c) losses of business property by fire, storm, or other casualty, or theft, not compensated for by insurance or otherwise and not made good by repairs claimed as deductions. Explain these deductions in Schedule B.

The amount claimed for wear and tear (depreciation), including obsolescence, should not exceed the original cost of the property (or if acquired prior to March 1, 1913, the fair market value on that date) divided by its estimated life in years. If obsolescence is claimed, state why useful life is less than actual life. When the amount of depreciation and obsolescence allowed equals the cost of the property (or if acquired prior to March 1, 1913, the fair market value on that date), no further claim should be made.

Do not claim any deduction for depreciation in the value of a building occupied by any beneficiary as a dwelling, or of other property held for personal use, nor for land (exclusive of improvements thereon), nor on stocks, bonds, and other securities.

Depreciation of patents, copyrights, etc., and depletion of mines, etc.—If you claim a deduction on account of depreciation in the value of patents, copyrights, franchises, and other legal privileges, or on account of depletion of mines or oil and gas wells, see Section 214 (a) 8 and 10, of the Revenue Act of 1921.

Amortization of war facilities.—If amortization of war facilities is claimed, see Section 214 (a) 9, of the Revenue Act of 1921, and the Regulations issued under authority thereof.

Bad debts.—Enter on line 16 debts, or portions thereof, arising from sales that have been reported as income, which have been definitely ascertained to be worthless and charged off within the year, or such reasonable amount as has been added to a reserve for bad debts within the year. A debt previously charged off as bad, if subsequently collected, must be returned as income for the year in which collected.

Other expenses.—Enter on line 17 all ordinary and necessary business expenses not classified above, such as fire insurance, heat, and light.

Do not include cost of business equipment or furniture, expenditures for replacements, or for permanent improvements to property, or living and family expenses of any beneficiary.

Loss.—If line 20 shows a deficit, indicate by using red ink or a minus sign.

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17. PROFIT FROM SALE OF REAL ESTATE.

Describe the property briefly, as "farm," "house," "lot."

State the actual consideration or price received, or, in case of an exchange, the fair market value of the property received.

Enter the original cost of the property if purchased by the fiduciary, and if it was acquired in any manner prior to March 1, 1913, the fair market value on that date. In case the property was owned by the decedent, the basis for computing profit (or loss) is the inventory value at the date of death. Attach statement explaining how value at March 1, 1913, was determined. Expenses incidental to the purchase may be included in the cost if never claimed in income tax returns as deductions from income.

Enter as depreciation the amount of wear and tear and obsolescence, or depletion, sustained since March 1, 1913 (or since date of acquisition, if subsequent to March 1, 1913).

In case the property was acquired by gift, bequest, devise, or inheritance after March 1, 1913, or in any manner prior to that date, see Section 202 of the Revenue Act of 1921.

If the net result to be entered in Item 5 is a deductible loss, indicate the deficit by using red ink or a minus sign.

18. PROFIT FROM SALE OF STOCKS, BONDS, ETC.

The method of computation and the information to be submitted in the case of sales of stocks, bonds, etc., is similar to that required for Item 5, except that subsequent improvements and depreciation are not involved. The profit (or loss) should be computed in accordance with Instruction 17 above.

19. OTHER INCOME.

Report all other taxable income for which no place is provided elsewhere on page 1 of the return, including dividends received on stock of foreign corporations, and corporations satisfying the conditions provided in Section 262 of the Revenue Act of 1921.

20. INTEREST PAID.

Enter as Item 10 interest paid on other indebtedness as distinguished from business indebtedness (which should be deducted under Schedules A, B, C, or D). Do not include interest on indebtedness incurred for the purchase of bonds and other obligations, the interest on which is wholly exempt from tax, except interest on indebtedness incurred to purchase or carry Victory Liberty Loan $3\frac{3}{4}$% Notes, originally subscribed for by the taxpayer.

21. TAXES PAID.

Enter as Item 11 personal taxes paid and all taxes on property not used in business, not including those assessed against local benefits of a kind tending to increase the value of the property. Do not include Federal income taxes, taxes imposed upon the estate or trust on its interest as stockholder of a corporation, which are paid by the corporation without reimbursement from the taxpayer, nor income and profits taxes reported in column 6, Item 18, page 1 of the return.

22. LOSSES BY FIRE, STORM, ETC.

Enter as Item 12 losses of property not connected with the trade, or business, sustained during the year from fire, storm, shipwreck, or other casualty, or from theft, which were not compensated for by insurance or otherwise. Losses claimed should be explained in Schedule E, on page 2 of the return. (See Section 214(a) 6 of the Revenue Act of 1921.)

23. CONTRIBUTIONS.

Enter as Item 13 any part of the gross income which, pursuant to the terms of the will or deed creating the trust, was during the accounting period paid to or permanently set aside for the use of (a) the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (b) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the Women's Auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (c) the special fund for vocational rehabilitation authorized by Section 7 of the Vocational Rehabilitation Act. List names of organizations and amounts contributed to each in Schedule F.

24. BAD DEBTS.

Enter as Item 14 all bad debts other than those claimed as a deduction in items above. State in Schedule F, (a) of what the debts consisted, (b) when they were created, (c) when they became due, and (d) how they were actually determined to be worthless.

25. OTHER AUTHORIZED DEDUCTIONS.

Enter as Item 15 all other deductions authorized by law for which no place is provided elsewhere on page 1 of the return. Do not deduct losses incurred in transactions which were neither connected with the trade or business nor entered into for profit. Any deduction claimed should be explained in Schedule F.

GOVERNMENT PRINTING OFFICE

Form 1040
U. S. INTERNAL REVENUE

IF RETURN IS FOR CALENDAR YEAR 1921 FILE IT WITH THE COLLECTOR OF INTERNAL REVENUE FOR YOUR DISTRICT ON OR BEFORE MARCH 15, 1922

IF FOR A PERIOD OTHER THAN A CALENDAR YEAR THE RETURN SHOULD BE FILED ON OR BEFORE THE 15TH DAY OF THE THIRD MONTH FOLLOWING THE CLOSE OF SUCH PERIOD

INDIVIDUAL INCOME TAX RETURN

FOR NET INCOMES OF MORE THAN $5,000, OR SEPARATE RETURNS OF HUSBAND AND WIFE IF COMBINED NET INCOME EXCEEDS $5,000

FOR CALENDAR YEAR 1921

Or for period begun ...., 1920, and ended ...., 1921

PRINT NAME AND ADDRESS PLAINLY BELOW

.... (Name)

.... (Street and number or rural route)

.... (Post office) .... (County) .... (State)

Do not write in this space
FIRST PAYMENT
$ ....
Cashier's Stamp

CASH CHECK M O CERT. OF IND.
Examined by

OCCUPATION, PROFESSION, OR KIND OF BUSINESS ....

I swear (or affirm) that this return, including the accompanying schedules and statements (if any), has been examined by me, and, to the best of my knowledge and belief, is a true and complete return made in good faith, for the taxable period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under authority thereof.

.... (If return is made by agent, the reason therefor must be stated on this line.)

Sworn to and subscribed before me this .... day of ...., 1922.

.... (Signature of individual or agent.)

.... (Signature of officer administering oath.) .... (Title)

.... (Address of individual or agent.)

1 Are you a citizen or resident of the United States? ....

2 If you filed a return for 1920, to what Collector's office was it sent? ....

3 Is this a joint return of husband and wife? ....

4 If not, is a separate return being filed by your husband or wife? ....

If so, state. (a) Name and address entered at head of that return ....

(b) Exemption claimed, $..............................

5 Were you married and living with husband or wife on the last day of your taxable period? ....

6. If not, were you on the last day of your taxable period supporting one or more persons living in your household who are closely related to you by blood, marriage, or adoption? ....

7 How many dependent persons (other than husband or wife) under 18 years of age or incapable of self support because mentally or physically defective were receiving their chief support from you on the last day of your taxable period? ....

See Instruction Number	Explain in Schedule (page 2)	INCOME.		
13	G	1 Salaries, Wages, Commissions, etc (State name and address of person from whom received.) Amount received $ .... Expenses paid $	$	
		2 Interest on Bank Deposits, Notes, Mortgages and Corporation Bonds		
14		3 Income from Partnerships, Fiduciaries, etc (State name and address of partnerships, etc.)		
15	A	4 Rents and Royalties		
16	B	5 Profit (or loss) from Business or Profession (not including income from partnerships)		
17	C	6 Profit (or loss) from Sale of Real Estate		
18	D	7 Profit (or loss) from Sale of Stocks, Bonds, etc		
		8 Dividends on Stock of Domestic Corporations		
19	E	9 Taxable Interest on Liberty Bonds, etc		
20		10 Other Income (including dividends received on stock of foreign corporations) (State nature of income.) (a) .... (b) .... (c)		
		11 TOTAL INCOME IN ITEMS 1 TO 10 (less losses shown thereon, if any)		$
		DEDUCTIONS.		
21		12 Interest Paid (not including interest deducted above)	$	
22		13 Taxes Paid (not including taxes deducted above)		
23	F	14 Losses by Fire, Storm, etc		
24	G	15 Contributions		
25	G	16 Bad Debts (not including bad debts deducted above)		
26	G	17 Other Deductions Authorized by Law		
		18 TOTAL OF ITEMS 12 TO 17		
		19 NET INCOME (Item 11 minus Item 18)		$

COMPUTATION OF TAX.

	20 Net Income (Item 19 above)		$	
	21 Less Dividends (Item 8 above)	$		
	22 Taxable Interest on Liberty Bonds, etc (Item 9 above)			
8	23 Personal Exemption and Credit for Dependents			
	24 TOTAL OF ITEMS 21, 22 AND 23			
	25 Balance (Item 20 minus Item 24)		$	
	26 Amount taxable at 4% (not over $4,000)			
	27 Balance taxable at 8% (Item 25 minus Item 26)		$	
11	**Checks and drafts will be accepted only if payable at par.**			

28 Normal tax (4% of Item 26)		$	
29 Normal tax (8% of Item 27)			
30 Surtax on Item 20 (See Instruction 6)			
31 TOTAL TAX		$	
32 Less: Tax paid at source	$		
33 Income tax paid, if any, to [illegible]			
34 Balance due (Item 31 minus Items 32 and 33)		$	
35 Amount of tax paid when filing return		$	

SCHEDULE A.—EXPLANATION OF ITEM 4. (Rents and Royalties.) See Instruction 17.

1. Kind of Property.	2. Cost, or March 1, 1913, Value	3. Amount Received	4. Repairs	5. Depreciation and Depletion.	6. Other Expenses	7. Net Profit (or Loss)
	$	$	$	$	$	$

State estimated life of property and how you figured depreciation

SCHEDULE B.—EXPLANATION OF ITEM 5. (Business or Profession. See Instruction 16.)

1. Total income from business or profession $

Cost of Goods Sold

2. Labor $
3. Material and supplies
4. Merchandise bought for sale
5. Other costs (list principal items and amounts below or on separate sheet)
6. Plus inventory at beginning of year
7. Total $
8. Less inventory at end of year
9. Net Cost of Goods Sold $

Other Business Deductions:

10. Salaries and wages not reported as "Labor" on line 2 (see Instruction 13) $
11. Rent on business property, in which taxpayer has no equity
12. Interest on business indebtedness to others
13. Taxes on business and business property
14. Repairs, wear and tear, obsolescence, depletion, and property loss (explain below)
15. Amortization of facilities
16. Bad debts arising from sales or services, if already reported as income
17. Other expenses (list principal items and amounts below or on separate sheet)
18. Total (Items 10 to 17, inclusive) $
19. Net Cost, plus Total Deductions (Item 9 plus Item 18) $
20. Net Profit (or Loss) from Business or Profession (Item 1 minus Item 19) $

Explanation of deductions

SCHEDULE C.—EXPLANATION OF ITEM 6. (Sale of Real Estate.) See Instruction 17.

1. Kind of Property.	2. Date Acquired.	3. Amount Received.	4. Cost.	5. March 1, 1913, Value	6. Subsequent Improvements.	7. Depreciation	8. Net Profit (or Loss).
		$	$	$	$	$	$

If not acquired by purchase, state how acquired

SCHEDULE D.—EXPLANATION OF ITEM 7. Sale of Stocks, Bonds, etc.) See Instruction 18.

1. Kind of Property	2. Date Acquired	3. Cost	4. March 1, 1913, Value	5. Amount Received	6. Net Profit (or Loss)
		$	$	$	$

If not acquired by purchase, state how acquired

SCHEDULE E.—EXPLANATION OF ITEM 9. (Taxable Interest on Liberty Bonds, etc.) See Instruction 19.

1. Obligations of the United States Issued Since September 1, 1917 (Wholly exempt from normal tax, but subject to surtax as to excess over exemptions specified.)	Exemptions Aggregate Principal Amount: 2. $5,000	3. [illegible]	4. [illegible]	5. Principal Amount in Excess of Exemptions Specified in Columns 2, 3, and 4	6. Interest on Principal Amount in Excess of Exemptions
(a) First Liberty Loan Second Converted 4¼% Bonds	$	$	$	$	$
(b) First, and Second 4's, and First, Second, Third, and Fourth 4¼'s	NONE				
(c) Other Obligations issued since September 1, 1917 (except Victory and Treasury Notes)	NONE	NONE			
(d) Victory Liberty Loan 4¾% Notes, and Treasury Notes	NONE	NONE	NONE		
(e) Total Taxable Interest (If you have bought or sold during the year attach statement showing holdings by periods)					$

SCHEDULE F.—EXPLANATION OF ITEM 14. (Losses by Fire, Storm, etc.) See Instruction 23.

1. Kind of Property.	2. Cost or March 1, 1913, Value.	3. Depreciation Previously Taken	4. Salvage Value	5. Insurance.	6. Net Loss.
	$	$	$	$	$

SCHEDULE G.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 1, 15, 16, AND 17.

(An amended return must be plainly marked "Amended" across the face of the return.)

Form 1040
U. S. Internal Revenue

INDIVIDUAL INCOME TAX RETURN

FOR NET INCOMES OF MORE THAN $5,000, OR SEPARATE RETURNS OF HUSBAND AND WIFE IF COMBINED NET INCOME EXCEEDS $5,000

DUPLICATE — FOR CALENDAR YEAR 1921 — **DUPLICATE**

Or for period begun ...., 1920, and ended ...., 1921

DETACH AND RETAIN THIS COPY AND THE INSTRUCTIONS

PRINT NAME AND ADDRESS PLAINLY BELOW

.... (Name)

.... (Street and number or rural route)

.... (Post office) .... (County) .... (State)

IF YOU NEED ASSISTANCE GO TO A DEPUTY COLLECTOR OR TO THE COLLECTOR'S OFFICE

OCCUPATION, PROFESSION, OR KIND OF BUSINESS ....

TAXPAYER'S RECORD OF PAYMENTS.

PAYMENT	AMOUNT	DATE	CHECK OR M. O. No.	BANK OR OFFICE OF ISSUE.
First				
Second				
Third				
Fourth				

1 Are you a citizen or resident of the United States? ....

2 If you filed a return for 1920, to what Collector's office was it sent? ....

3 Is this a joint return of husband and wife? ....

4 If not, is a separate return being filed by your husband or wife? .... If so, state [illegible] Name and address entered at head of that return ....

(b) Exemption claimed, $............

5 Were you married and living with husband or wife on the last day of your taxable period? ....

6 If not, were you on the last day of your taxable period supporting one or more persons living in your household who are closely related to you by blood, marriage, or adoption? ....

7 How many dependent persons (other than husband or wife) under 18 years of age or incapable of self support because mentally or physically defective were receiving their chief support from you on the last day of your taxable period? ....

INCOME.

See Instruction Number	Explanation Schedule (page 2)	Item		Amount
13	G	1 Salaries, Wages, Commissions, etc. (State name and address of person from whom received.)	Amount received. $...... Expenses paid. $......	$......
		....		
		....		
		2 Interest on Bank Deposits, Notes, Mortgages, and Corporation Bonds		
14		3 Income from Partnerships, Fiduciaries, etc. (State name and address of partnerships, etc.)		
		....		
15	A	4 Rents and Royalties		
16	B	5 Profit (or loss) from Business or Profession (not including income from partnerships)		
17	C	6 Profit (or loss) from Sale of Real Estate		
18	D	7 Profit (or loss) from Sale of Stocks, Bonds, etc.		
		8 Dividends on Stock of Domestic Corporations		
19	E	9 Taxable Interest on Liberty Bonds, etc.		
20		10 Other Income (including dividends received on stock of foreign corporations) (State nature of income.)		
		(a)		
		(b)		
		....		
		11 Total Income in Items 1 to 10 (less losses shown therein, if any)		$......

DEDUCTIONS.

21		12 Interest Paid (not including interest deducted above)	$......	
22		13 Taxes Paid (not including taxes deducted above)		
23	F	14 Losses by Fire, Storm, etc.		
24	G	15 Contributions		
25	G	16 Bad Debts (not including bad debts deducted above)		
26	G	17 Other Deductions Authorized by Law		
		18 Total of Items 12 to 17		
		19 Net Income (Item 11 minus Item 18)		$......

COMPUTATION OF TAX.

	20 Net Income (Item 19 above)		$......
	21 Less: Dividends (Item 8 above)	$......	
	22 Taxable Interest on Liberty Bonds, etc. (Item 9 above)		
8	23 Personal Exemption and Credit for Dependents		
	24 Total of Items 21, 22 and 23		
	25 Balance (Item 20 minus Item 24)		$......
	26 Amount taxable at 4% (not over $4,000)		
	27 Balance taxable at 8% (Item 25 minus Item 26)		$......
31	Checks and drafts will be accepted only if payable at par.		

28. Normal tax (4% of Item 26)		$......
29. Normal tax (8% of Item 27)		
30. Surtax on Item 20 (see Instruction 6)		
31 Total Tax		$......
32 Less: Tax paid at source	$......	
33 Income and profits taxes paid to foreign countries or possessions of the U. S. (attach Form 1116)		
34 Balance due (Item 31 minus Items 32 and 33)		$......
35 Amount of tax paid when filing return		$......

SCHEDULE A.—EXPLANATION OF ITEM 4. Rents and Royalties. (See Instruction 11.)

1. Kind of Property	2. Cost or March 1, 1913, Value	3. Amount Received	4. Repairs	5. Depreciation and Depletion	6. Other Expenses	7. Net Profit or Loss
	$	$	$	$	$	$

State [illegible]

SCHEDULE B.—EXPLANATION OF ITEM 5. Business or Profession. (See Instruction [illegible])

1. Total income from business or profession .... $

Cost of Goods Sold

2. Labor .... $
3. Materials and supplies ....
4. Merchandise bought for sale ....
5. Other costs (list principal items and amounts below or on separate sheet) ....
6. Plus inventory at beginning of year ....
7. Total ....
8. Less inventory at end of year ....
9. Net Cost of Goods Sold .... $

Other Business Deductions

10. Salaries and wages not reported as "Labor" on line 2 (see Instructions 13) .... $
11. Rent of business property in which taxpayer has no equity ....
12. Interest on business indebtedness to others ....
13. Taxes on business and business property ....
14. Repairs, wear and tear, obsolescence, depletion, and losses (explain below) ....
15. [illegible] ....
16. Bad debts arising from sales or services [illegible] ....
17. Other expenses (list principal items and amounts below or on separate sheet) ....
18. Total Items 10 to 17, inclusive .... $
19. Net Cost, plus Total Deductions (Item 9 plus Item 18) .... $
20. Net Profit (or Loss) from Business or Profession (Item 1 minus Item 19) .... $

Explanation of deductions ....

SCHEDULE C.—EXPLANATION OF ITEM 6. (Sale of Real Estate.) (See Instruction 17.)

1. Kind of Property	2. Date Acquired	3. Amount Received	4. Cost	5. March 1, 1913, Value	6. Subsequent Improvements	7. Depreciation	8. Net Profit (or Loss)
		$	$	$	$	$	$

If not acquired by purchase, state how acquired ....

SCHEDULE D.—EXPLANATION OF ITEM 7. (Sale of Stocks, Bonds, etc.) (See Instruction 18.)

1. Kind of Property	2. Date Acquired	3. Cost	4. March 1, 1913, Value	5. Amount Received	6. Net Profit (or Loss)
		$	$	$	$

If not acquired by purchase, state how acquired ....

SCHEDULE E.—EXPLANATION OF ITEM 9. (Taxable Interest on Liberty Bonds, etc.) (See Instruction 19.)

1. Obligations of the United States Issued Since September 1, 1917 (Wholly exempt from normal tax, but subject to surtax on amount over exemptions specified.)	Exemptions (Aggregate principal amount.) 2. $30,000	3. $125,000	4. $5,000	5. Principal Amount in Excess of Exemptions Specified in Columns 2, 3, and 4.	6. Interest on Principal Amount in Excess of Exemptions.
(a) First Liberty Loan Second Converted 4¼% Bonds	$	$	$	$	$
(b) First, and Second 4's, and First, Second, Third, and Fourth 4¼'s	NONE				
(c) Other Obligations issued since September 1, 1917 except Victory and Treasury Notes	NONE	NONE			
(d) Victory Liberty Loan 4¾% Notes, and Treasury Notes	NONE	NONE	NONE		
(e) Total Taxable Interest (If you have bought or sold during the year attach statement showing holdings by periods)					$

SCHEDULE F.—EXPLANATION OF ITEM 14. (Losses by Fire, Storm, etc.) See Instruction 23.

1. Kind of Property.	2. Cost, or March 1, 1913, Value.	3. Depreciation Previously Taken	4. Salvage Value.	5. Insurance.	6. Net Loss.
	$	$	$	$	$

SCHEDULE G.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 1, 15, 16, AND 17.

(An amended return must be plainly marked "Amended" across the face of the return.)

INSTRUCTIONS FOR INDIVIDUAL RETURN

1. PERSONS REQUIRED TO MAKE A RETURN OF INCOME.

An income tax return must be filed by every citizen of the United States whether residing at home or abroad, and every person residing in the United States, though not a citizen thereof, whose gross income for the taxable period 1921 amounted to $5,000, or whose net income amounted to—

(a) $1,000 if single or if married and not living with husband or wife.

(b) $2,000 if married and living with husband or wife.

If the combined net income of husband, wife, and dependent minor children equalled or exceeded $2,000, or if the combined gross income of husband, wife, and dependent minor children equalled or exceeded $5,000 all such income must be reported on a joint return, or on separate returns of husband and wife. If single and the net income, including that of dependent minors, if any, equalled or exceeded $1,000, or if the gross income equalled or exceeded $5,000, a return must be filed. A minor, however, having a net income of $1,000 or $2,000, according to the marital status, or a gross income of $5,000, must file a return.

Under each of the above conditions, a return must be filed even though no tax is due. Note especially Instruction 8, "Credits for Personal Exemption and Dependents."

The income of a minor or incompetent, if derived from a separate estate under control of a guardian, trustee, or other fiduciary, must be reported by his guardian or other legal representative.

Income of (a) estates of decedents before final settlement; (b) trusts, whether created by will or deed, for unascertained persons or persons with contingent interests, or income held, or which under the terms of the will or trust may be held, for future distribution, is taxed to the fiduciary as a single person, except that from the income of an estate there may first be deducted any amount properly paid or credited to beneficiaries.

If the net income of a decedent from the beginning of the taxable period to the date of his death was $1,000, if unmarried, or $2,000, if married and living with wife or husband, or if the gross income was $5,000 or over, the executor or administrator shall file a return on Form 1040 or 1040A for such decedent.

2. WHEN TO USE FORM 1040 INSTEAD OF THIS FORM.

You must file your return on Form 1040—

(a) If the combined net income of husband and wife exceeds $5,000

(b) If your net income exceeds $5,000.

(c) If the net income reported in this return exceeds $4,000 and the entire family exemption has been claimed in a separate return filed by husband or wife

(d) If the return is filed for a period of less than one year and the net income when placed on an annual basis exceeds $5,000. (See Instruction 3 below.)

3. PERIOD TO BE COVERED BY RETURN.

Your return must be filed for the calendar year ending December 31, 1921, or for the fiscal year ending on the last day of any month other than December. The dates on which the period covered by the return begins and ends, if other than a calendar year, must be plainly stated at the head of the return.

You were required to file your return for 1918 on the basis of your annual accounting period. Having established an accounting period for 1918 this period must be adhered to for subsequent years, unless permission was received from the Commissioner to make a change. In the case of a return for a period of less than one year, the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

4. ACCRUED OR RECEIVED INCOME.

If your books of account are kept on an accrual basis, report all income accrued, even though it has not been actually received or entered on the books, and expenses incurred instead of expenses paid.

If your books do not show income accrued and expenses incurred, report all income received or constructively received, such as bank interest credited to your account, and expenses paid.

5. INSTALLMENT SALES.

If you have used the installment method in computing income from installment sales you must attach to your return a schedule showing separately for the years 1918, 1919, 1920, and 1921 the following information: (a) Gross sales; (b) cost of goods sold; (c) gross profits; (d) percentage of profits to gross sales; (e) amount collected; (f) gross profit on amount collected.

6. ITEMS EXEMPT FROM TAX.

The following items are exempt from Federal income tax and should not be reported, unless it is desired to establish a net loss, in which case see Section 204 of the Revenue Act of 1921:

(a) The proceeds of life insurance policies paid upon the death of the insured;

(b) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(c) Gifts (not made as a consideration for service rendered), and money and property acquired under a will or by inheritance (but the income derived from money or property received by gift, will, or inheritance is taxable and must be reported);

(d) Interest upon (1) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (2) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (3) the obligations of the United States or its possessions, or (4) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest is exempt only if and to the extent provided in the respective acts authorizing the issue thereof as amended and supplemented by Section 1328 of the Revenue Act of 1921, and should be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war profits, and excess profits taxes;

(e) Amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness;

(f) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;

(g) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation;

(h) Compensation paid by a State or political subdivision thereof to its officers or employees.

7. FARMER'S INCOME SCHEDULE.

If you are a farmer or a farm owner renting your farm out on shares and keep no books of account, or keep books on a cash basis, obtain from the Collector, and attach to this return, Form 1040 F, Schedule of Farm Income and Expenses. Enter the net farm income as Item 5, page 1 of the return. If your farm books of account are kept on an accrual basis, the filing of Form 1040F is optional. Report income from salaries, interest, rents, sales of property, etc., in Items 1 to 7 of the return.

8. CREDITS FOR PERSONAL EXEMPTION AND DEPENDENTS.

If you were married and living with your husband or wife or were head of a family on the last day of your taxable period, you may subtract from your net income on Form 1040A, before calculating your normal tax, an exemption of $2,500, plus $400 for each person (other than husband or wife) under 18 years of age or incapable of self-support because mentally or physically defective, who was receiving his chief support from you on that date. If husband and wife make separate returns, the exemption of $2,500 may be claimed by either (but not by both) or may be divided between them, but the exemption of $400 for each dependent may be claimed only by the person furnishing the chief support.

If you were not married or did not live with husband or wife and were not head of a family on the last day of your taxable period, you are entitled to a personal exemption of $1,000 plus $400 for each dependent person under 18 years of age or incapable of self-support because mentally or physically defective, who was receiving his chief support from you on that date.

An exemption of $1,000 may be claimed in cases where Form 1040A is filed for estates in process of administration, or with respect to income held for future distribution.

If by reason of a change in your accounting period a return is filed for part of a year, the personal exemption and credit for dependents may be claimed in accordance with your status on the last day of such taxable period. (See also Instruction 3 on this page.)

A "head of family" is a person who actually supports one or more persons living in his (or her) household, who are closely related to him (or her) by blood, marriage, or adoption.

9. AFFIDAVIT.

The affidavit must be executed by the person whose income is reported unless he is a minor or incompetent, or unless he is ill, absent from the country, or otherwise incapacitated, in which case the legal representative or agent may execute the affidavit. A minor, however, making his own return, must execute the affidavit.

The oath will be administered without charge by any collector, deputy collector, or internal revenue agent, or (if you are in the military or naval service of the United States) by any military or naval officer who is authorized to administer oaths for purposes of military or naval justice and administration. If an internal revenue officer is not available, the return should be sworn to before a notary public, justice of the peace, or other person authorized to administer oaths.

10. WHEN AND WHERE THE RETURN MUST BE FILED.

If the return is for the calendar year 1921, file it with the Collector of Internal Revenue for the district in which you live or have your principal place of business on or before March 15, 1922. If for a period other than the calendar year, the return should be filed on or before the 15th day of the third month following the close of such period.

In case the taxpayer had no legal residence or place of business in the United States, the return should be forwarded to the Collector of Internal Revenue, Baltimore, Md.

If the address of the collector is not printed on the return and you do not know it, ask at the post office or bank.

11. WHEN AND TO WHOM THE TAX MUST BE PAID.

The tax should be paid, if possible, by sending or bringing with the return a check or money order drawn to the order of "Collector of Internal Revenue at (insert name of city and State)."

Do not send cash through the mail, or pay it in person, except at the office of the collector.

The tax may be paid in four equal installments as follows: The first installment shall be paid at the time fixed by law for filing the return, the second installment shall be paid on the 15th day of the third month, the third installment on the 15th day of the sixth month, and the fourth installment on the 15th day of the ninth month after the time fixed by law for filing the return.

The total tax may be paid at the time of filing the return, or if not so paid, one installment must be paid and the balance may be paid in installments, or in full, on or prior to any subsequent installment date referred to above. Failure to pay any installment on the date fixed by law makes the taxpayer liable for the payment of the balance of tax due upon notice and demand by the collector.

12. PENALTIES.

For Making False or Fraudulent Returns.

Not exceeding $10,000 or not exceeding one year's imprisonment, or both, in the discretion of the court, and, in addition, 50 per centum of the tax evaded.

For Failing to Make Return on Time.

Not more than $1,000, and, in addition, 25 per centum of the total tax.

For Failing to Pay Tax When Due, or Understatement of Tax Through Negligence, etc.

Five per cent of the tax due but unpaid, plus interest at the rate of 1 per centum per month during the period in which it remains unpaid.

13. INCOME FROM SALARIES, WAGES, COMMISSIONS, ETC.

Report all salaries or other compensation credited by or received from outside sources, and any salaries [illegible] on line 10, Schedule B, [illegible] yourself [illegible] your wife (or husband), [illegible] and for each dependent minor child having a net income of less [illegible] per annum. Use a separate line for each entry, giving the information required.

[illegible] as a deduction for necessary expenses against salaries, etc., should be [illegible] Schedule G, page 2 of the return, or in an attached statement.

Traveling [illegible] (the entire amount expended for meals and lodging) while away [illegible] in the pursuit of a trade or business are deductible.

14. INCOME FROM PARTNERSHIPS, FIDUCIARIES, ETC.

[illegible] (whether received or not) in the profits of a partnership or personal service [illegible] the income of an estate or trust, except the part of such share that [illegible] stock of domestic corporations, and taxable interest on [illegible], which should be included in Items 8 and 9, respectively, page 1 of the return.

[illegible] in Item 1, salary received from a partnership or personal service corporation.

[illegible] taxable [illegible] for the basis of which you file your return [illegible] with the annual accounting period of the partnership, personal service corporation, or fiduciary, then you should include in your return your distributive share of the total net income for such accounting period ending within your taxable period.

15. INCOME FROM RENTS AND ROYALTIES.

If you received property or crops in lieu of cash rent, report the income as though the rent had been received in cash. Crops received as rent on a crop-share basis should be reported as income for the year in which disposed of (unless your return shows income accrued).

Explain in Schedule A repairs, depreciation, depletion, and other expenses.

Other expenses include interest, taxes, fire insurance, fuel, light, labor, and other necessary expenses of this character.

16. INCOME FROM BUSINESS OR PROFESSION.

Report in Item 5 the net profit (or loss) from—

(a) Sale of merchandise, or of products of manufacturing, construction, mining, and agriculture.

(b) Business service, such as transportation, storage, laundering, hotel and restaurant service, livery and garage service, etc., if you owned the business. If you are an employee of a business, report your salary or wages in Item 1.

(c) A profession, such as medicine, law, or dentistry, if you practiced it on your own account. If you were employed on a salary, report your salary in Item 1.

In general, report in Item 5, any income in the earning of which you incurred expenses for labor, rent, etc.

If you are a farmer (or a farm owner renting your farm to another person on shares), see Instruction 7.

Describe the business or profession in the space provided on page 1 as "grocery," "retail clothing," "drug store," "laundry," "doctor," "lawyer," "farmer," etc., and fill in Schedule B, page 2 of the return.

Enter on line 1, Schedule B, the total income from sales [illegible] discounts or allowances from the sale price or [illegible] Instruction [illegible]

If you are engaged in a trade or business in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, secure from the Collector of Internal Revenue and file as a part of this return a *Certificate of Inventory, Form 1125*.

Salaries.—Enter on line 10 all salaries and wages not reported as "Labor" on line 2. Salary or wages for your own services or the services of your dependent minor children, if deducted, must be reported as income in Item 1.

Rent.—Enter on line 11 rent on business property in which you have no equity. Do not include rent for dwelling you occupy for residential purposes.

Interest.—Enter on line 12 interest on business indebtedness to others. Do not include interest to yourself on capital invested in or advanced to the business.

Taxes.—Enter on line 13 taxes on business property or for carrying on business. Do not include taxes assessed against local benefits of a kind tending to increase the value of the property assessed, as for paving, sewers, etc., nor Federal income taxes.

Repairs, wear and tear, obsolescence, depletion, and property losses (other than merchandise).—Enter on line 14, (a) ordinary repairs required to keep property in usable condition, (b) reasonable allowance for exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence, and [illegible] property by fire, storm, or other casualty, or theft, not compensated for by insurance or otherwise and not made good by repairs claimed as deductions. Explain these deductions in Schedule B.

The amount claimed for wear and tear (depreciation), including obsolescence, should not exceed the original cost of the property (or if acquired prior to March 1, 1913, the fair market value on that date) divided by its estimated life in years. If obsolescence is claimed, state why useful life is less than actual life. When the amount of depreciation and obsolescence allowed equals the cost of the property (or if acquired prior to March 1, 1913, the fair market value on that date), no further claim should be made.

Do not claim any deduction for depreciation in the value of a [illegible] occupied by you as a dwelling, or of other property held for personal use, nor for land (exclusive of improvements thereon), nor on stocks, bonds, and other securities.

Depreciation of patents, copyrights, etc., and depletion of [illegible].—If you claim a deduction on account of depreciation in the value of patents, copyrights, [illegible] and other legal privileges, or on account of depletion of mines or oil and gas wells, see Section 214 (a) 8 and 10, of the Revenue Act of 1921.

Amortization of cost of [illegible].—[illegible] on of war facilities [illegible] Section 214 (a) 9, of the Revenue Act of 1921 and the Regulations [illegible]

Bad debts.—Enter on line 16 debts or portions [illegible] personal services that have been reported as income, which have been [illegible] to be worthless and charged off within the year, or such reasonable amount [illegible] to a reserve for bad debts within the year. A debt previously charged off as bad, if subsequently collected, must be returned as income for the year in which collected.

Other expenses.—Enter on line 17 all ordinary and necessary business expenses not classified above, such as fire insurance, heat, light, and traveling expenses (see Instruction 13).

Do not include cost of business equipment or furniture, expenditures for replacements, or for permanent improvements to property, nor personal, living, or family expenses.

Deficit.—If Item 20 shows a deficit, indicate by using red ink or a minus sign.

17. PROFIT FROM SALE OF REAL ESTATE.

Describe the property briefly, as "farm," "house," "lot."

State the actual consideration or price received, or, in case of an exchange, the fair market value of the property received.

Enter the original cost of the property, and if it was acquired prior to March 1, 1913, the fair market value on that date. Attach statement explaining how value as of March 1, 1913, was determined. Expenses incidental to the purchase may be included in the cost if never claimed in income tax returns as [illegible]

Enter [illegible] the amount [illegible] sustained since March 1, 1913 [illegible] March 1, [illegible]

In case the property was [illegible] 1, 1913 or in any [illegible] prior to that date [illegible]

If the net [illegible] to be entered in Item 6 is a deduction [illegible], using red ink or a minus sign.

18. PROFIT FROM SALE OF STOCKS, BONDS, ETC.

The method [illegible] of stocks [illegible] ments and [illegible] The profit [illegible] accordance with Instruction 17 above.

19. TAXABLE INTEREST ON LIBERTY BONDS, ETC.

The interest on Liberty Bonds and other obligations of the United States [illegible] September 1, 1917 [illegible] Victory Liberty Loan [illegible] of [illegible] provided by the act authorizing the issue and subsequent acts.

The [illegible] in columns 2, 3, and 4, Schedule E [illegible] obligations [illegible] that the total amount entered [illegible] any one column [illegible] The [illegible] at head of columns [illegible] obligations [illegible]

Enter in column [illegible] owned [illegible] share [illegible]

To determine the interest on any class of obligations [illegible] period [illegible] amount of all coupons and registered bond interest [illegible] the amount of accrued interest received [illegible] date and [illegible] from that sum the accrued interest [illegible] between interest payment dates. This method [illegible] on such bonds, whether or not the coupons [illegible] due within the taxable [illegible] cashed.

If the books are kept on the accrual basis, report the actual amount of interest accrued on the obligations owned during the taxable period.

20. OTHER INCOME.

Report all other taxable income for which no place is provided elsewhere on page 1 of the return, including [illegible] corporations.

21. INTEREST PAID.

Enter as Item 12 interest paid on personal indebtedness [illegible] in [illegible] which should be [illegible] Schedule B [illegible] interest [illegible] indebtedness incurred [illegible] tions the interest on which is wholly exempt from tax [illegible] incurred to purchase or carry Victory Liberty Loan [illegible] by the taxpayer.

22. TAXES PAID.

Enter as Item 13 personal taxes paid and all taxes on property not used in business or profession, not including those assessed against local benefits of a kind tending to increase the value of the property. Do not include Federal income taxes, taxes imposed upon the taxpayer upon his interest [illegible] of a corporation which are paid by the corporation without reimbursement from the taxpayer, nor income and profits taxes claimed as a credit in Item [illegible] page 1 of the return.

23. LOSSES BY FIRE, STORM, ETC.

Enter as Item 14 losses of property not connected with your trade or business or profession sustained during the year from fire, storm, shipwreck, or other casualty, or from theft, which were not compensated for by insurance or otherwise. (Losses claimed should be explained in Schedule [illegible] page 2 of the return.)

Do not deduct losses [illegible] transactions which were neither connected with your trade or business, nor entered into for profit.

24. CONTRIBUTIONS.

Enter as Item 15 contributions or gifts made within the taxable period to or for the use of [illegible] the United States [illegible] thereof, [illegible] or community chest, fund, or foundation [illegible] for religious, charitable [illegible] purposes, including posts of the American Legion or the Women's Auxiliary [illegible] holder [illegible] section 7 of the Vocational Rehabilitation Act, to an amount which in all the above cases combined does not exceed 15 per cent of the taxpayer's net income as computed without the benefit of this paragraph.

[illegible] in the process of administration [illegible] in [illegible] section [illegible] of the Revenue Act of 1921. List names of organizations [illegible] in Schedule G.

25. BAD DEBTS.

Enter as Item 16 [illegible] as a deduction in items above. State in Schedule G, [illegible] when they were created, when they became due, and [illegible] to be worthless.

26. OTHER AUTHORIZED DEDUCTIONS.

If there [illegible] deductions [illegible] Any deduction claimed in Item 17 should be explained in Schedule G.

Form 1040A
U. S. INTERNAL REVENUE

FILE RETURN WITH THE COLLECTOR OF INTERNAL REVENUE FOR YOUR DISTRICT ON OR BEFORE MARCH 15, 1922

INDIVIDUAL INCOME TAX RETURN

FOR NET INCOMES OF NOT MORE THAN $5,000

For Calendar Year 1921

Or for period begun ...., 1920, and ended ...., 1921

PRINT NAME AND ADDRESS PLAINLY BELOW

....
(Name.)

....
(Street and number or rural route.)

....
(Post office.) (County.) (State.)

Do not write in this space
FIRST PAYMENT

$..........................

(Cashier's Stamp)

CASH CHECK M. O.

Examined by

....

OCCUPATION, PROFESSION, OR KIND OF BUSINESS ....

*See Instruction Number	Explain in Schedule (page 2)	INCOME.		
13	F	1. Salaries, Wages, Commissions, etc. (State name and address of person from whom received.) *Amount received.* $...... *Expenses paid.* $......	$	
		2. Interest on Bank Deposits, Notes, Mortgages, and Corporation Bonds		
14		3. Income from Partnerships, Fiduciaries, etc. (State name and address of partnerships, etc.)		
15	A	4. Rents and Royalties		
16	B	5. Profit (or loss) from Business or Profession (not including income from partnerships) ..		
17	C	6. Profit (or loss) from Sale of Real Estate		
18	D	7. Profit (or loss) from Sale of Stocks, Bonds, etc.		
19		8. Other Income (except dividends from domestic corporations and interest on obligations of the U. S.) (State nature of income) (a)........ (b)........		
		9. TOTAL INCOME IN ITEMS 1 TO 8 (less losses shown above, if any)		$
		DEDUCTIONS.		
20		10. Interest Paid (not including interest deducted above)	$	
21		11. Taxes Paid (not including taxes deducted above)		
22	E	12. Losses by Fire, Storm, etc.		
23	F	13. Contributions		
24	F	14. Bad Debts (not including bad debts deducted above)		
25	F	15. Other Deductions Authorized by Law		
		16. TOTAL OF ITEMS 10 TO 15		$
		17. TAXABLE NET INCOME (Item 9 minus Item 16)		$

COMPUTATION OF TAX.

	18. Net Income (Item 17 above) .... $	21. Tax Due (4% of Item 20)	$
8	19. Less Personal Exemption and Credit for Dependents	22. Less: Tax Paid at Source .... $ 23. Income and profits taxes paid to a foreign country or possession of the United States (attach Form 1116)	
	20. Balance (Item 18 minus Item 19) .... $	24. Balance Due (Item 21 minus 22 and 23) ..	$
11	Checks will be accepted if payable at par at Collector's Office.	25. Tax Paid when Filing Return	$

SCHEDULE A.—EXPLANATION OF ITEM 4. (Rents and Royalties.)

1. Kind of property.	2. Cost, or March 1, 1913, value.	3. Amount received.	4. Repairs.	5. Depreciation and depletion.	6. Other expenses.	7. Net profit (or loss).

State estimated life of property and how you figured depreciation

SCHEDULE B.—EXPLANATION OF ITEM 5. (Business or Profession.)

Total Income from Business or Profession	
Total Business Expenses (state specifically, see Instruction 16)	
NET PROFIT (OR LOSS) (If profit is less than usual, explain)	

Explanation of business expenses

SCHEDULE C.—EXPLANATION OF ITEM 6. (Sale of Real Estate.)

1. Kind of property.	2. Date acquired.	3. Amount received.	4. Cost.	5. March 1, 1913, value.	6. Subsequent improvements.	7. Depreciation.	8. Net profit (or loss).

If not acquired by purchase, state how acquired

SCHEDULE D.—EXPLANATION OF ITEM 7. (Sale of Stocks, Bonds, etc.)

1. Kind of property.	2. Date acquired.	3. Cost.	4. March 1, 1913, value.	5. Amount received.	6. Net profit (or loss).

If not acquired by purchase, state how acquired

SCHEDULE E.—EXPLANATION OF ITEM 12. (Losses by Fire, Storm, etc.)

1. Kind of property.	2. Cost, or March 1, 1913, value.	3. Depreciation previously taken.	4. Salvage value.	5. Insurance.	6. Net loss.

SCHEDULE F.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 1, 13, 14, and 15.)

1. Are you a citizen or resident of the United States?

2. If you filed a return for 1920, to what Collector's office was it sent?

3. Is this a joint return of husband and wife?

4. Was a separate return filed by your husband or wife? If so, state: (a) Exemption claimed, $ (b) Name and address entered at head of that return

5. Were you married and living with husband or wife on the last day of your taxable period?

6. If not, were you on the last day of your taxable period supporting one or more persons living in your household who are closely related to you by blood, marriage, or adoption?

7. How many dependent persons (other than husband or wife) under 18 years of age or incapable of self-support because mentally or physically defective were receiving their chief support from you on the last day of your taxable period?

8. State amount of dividends received from domestic corporations (including dividends received through partnerships, fiduciaries, etc.) $

9. State amount of interest received on Victory Liberty Loan 4¾% Notes $

10. State amount of interest received on other obligations of the United States (except Liberty Bonds) on a principal in excess of $5,000 $

I SWEAR (or affirm) that this return, including the accompanying schedules and statements (if any), has been examined by me, and, to the best of my knowledge and belief, is a true and complete return, made in good faith, for the taxable period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under authority thereof.

(If return is made by agent, the reason therefor must be stated on this line.)

Sworn to and subscribed before me this .... day of ...., 1922.

(Signature of individual or agent.)

(Signature of officer administering oath.) (Title.) (Address of individual or agent.)

(An amended return must be plainly marked "Amended" across the face of the return.)

INSTRUCTIONS FOR INDIVIDUAL RETURN

1. PERSONS REQUIRED TO MAKE A RETURN OF INCOME.

An income tax return must be filed by every citizen of the United States whether residing at home or abroad, and every person residing in the United States, though not a citizen thereof, whose gross income for the taxable period 1921 amounted to $5,000, or whose net income amounted to—

(a) $1,000 if single or if married and not living with husband or wife

(b) $2,000 if married and living with husband or wife

If the combined net income of husband, wife, and dependent minor children equalled or exceeded $2,000, or if the combined gross income of husband, wife, and dependent minor children equalled or exceeded $5,000 all such income must be reported on a joint return, or on separate returns of husband and wife. If single and the net income, including that of dependent minors if any, equalled or exceeded $1,000 or if the gross income equalled or exceeded $5,000, a return must be filed. A minor, however, having a net income of $1,000 or $2,000, according to the marital status, or a gross income of $5,000, must file a return.

Under each of the above conditions a return must be filed even though no tax is due. Note especially Instruction 8, "Credits for Personal Exemption and Dependents."

In the case of husband and wife whose combined net income exceeds $5,000, Form 1040 (not Form 1040 A) should be used for separate returns even though the income on one or both returns is less than $5,000.

The income of a minor or incompetent, if derived from a separate estate under control of a guardian, trustee, or other fiduciary, must be reported by such legal representative.

Income of (a) estates of decedents before final settlement, (b) trusts, whether created by will or deed for unascertained persons or persons with contingent interests, or income held, or which under the terms of the will or trust may be held, for future distribution, is taxed to the fiduciary as a single person, except that from the income of a decedent's estate there may first be deducted an amount properly paid or credited to a beneficiary.

If the net income of a decedent from the beginning of the taxable period to the date of his death was $1,000, if unmarried, or $2,000, if married and living with husband or wife, or if the gross income was $5,000 or over, the executor or administrator shall file a return on Form 1040 or 1040A for such decedent.

2. PERIOD TO BE COVERED BY RETURN.

Your return must be filed for the calendar year ending December 31, 1921, or for the fiscal year ending on the last day of any month other than December. The dates on which the period covered by the return begins and ends, if other than a calendar year, must be plainly stated at the head of the return.

You were required to file your return for 1918 on the basis of your annual accounting period. Having established an accounting period for 1918 this period must be adhered to for subsequent years, unless permission was received from the Commissioner to make a change. In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period, and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

3. ACCRUED OR RECEIVED INCOME.

If your books of account are kept on an accrual basis, report all income accrued, even though it has not been actually received or entered on the books, and expenses incurred instead of expenses paid.

If your books do not show income accrued and expenses incurred, report all income received or constructively received, such as bank interest credited to your account, and expenses paid.

4. INSTALLMENT SALES.

If you have used the installment method in computing income from installment sales you must attach to your return a schedule showing separately for the years 1918, 1919, 1920, and 1921 the following information: (a) Gross sales; (b) cost of goods sold, (c) gross profits (d) percentage of profits to gross sales, (e) amount collected, (f) gross profit on amount collected.

5. ITEMS EXEMPT FROM TAX.

The following items are exempt from Federal income tax and should not be reported, unless it is desired to establish a net loss, in which case see Section 204 of the Revenue Act of 1921.

(a) The proceeds of life insurance policies paid upon the death of the insured;

(b) The amount received by the insurence as return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract,

(c) Gifts (not made as a consideration for service rendered), and money and property acquired under a will or by inheritance (but the income derived from money or property received by gift, will, or inheritance is taxable and must be reported);

(d) Interest upon (1) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (2) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (3) the obligations of the United States or its possessions; or (4) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest is exempt only if and to the extent provided in the respective acts authorizing the issue thereof as amended and supplemented by section 1328 of the Revenue Act of 1921, and should be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war profits, and excess profits taxes;

(e) Amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received, whether by suit or agreement, on account of such injuries or sickness,

(f) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war,

(g) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation,

(h) Compensation paid by a State or political subdivision thereof to its officers or employees

7. FARMER'S INCOME SCHEDULE.

If you are a farmer or a farm owner renting your farm out on shares and keep no books of account, or keep books on a cash basis, obtain from the Collector, and attach to this return Form 1040F, Schedule of Farm Income and Expenses. Enter the net farm income as Item 5, page 1 of the return. If your farm books of account are kept on an accrual basis, the filing of Form 1040F is optional. Report income from salaries interest, rents sales of property, etc., in Items 1 to 7 of the return.

8. CREDITS FOR PERSONAL EXEMPTION AND DEPENDENTS.

If you were married and living with your husband or wife or were head of a family on the last day of your taxable period, you may subtract from your net income on Form 1040, before calculating your normal tax, an exemption of $2,000, plus $400 for each person (other than husband or wife) under 18 years of age or incapable of self-support because mentally or physically defective, who was receiving his chief support from you on that date, but in no case shall the tax, computed with an exemption of $2,000, exceed the tax which would be payable if the exemption were $2,500 by more than the amount of the net income in excess of $5,000. If husband and wife make separate returns, the exemption of $2,000 may be claimed by either (but not by both) or may be divided between them but the credit of $400 for each dependent may be claimed only by the person furnishing the chief support.

If you were not married or did not live with husband or wife and were not head of a family on the last day of your taxable period, you are entitled to a personal exemption of $1,000 plus $400 for each dependent person under 18 years of age or incapable of self support because mentally or physically defective, who was receiving his chief support from you on that date.

An exemption of $1,000 may be claimed in cases where Form 1040 is filed for estates in process of administration, or with respect to income held for future distribution.

If by reason of a change in your accounting period a return is filed for part of a year the personal exemption and credit for dependents may be claimed in accordance with your status on the last day of such taxable period. (See also Instruction 2 on this page.)

A "head of family" is a person who actually supports one or more persons living in his (or her) household, who are closely related to him (or her) by blood, marriage, or adoption.

9. AFFIDAVIT.

The affidavit must be executed by the person whose income is reported unless he is a minor or incompetent, or unless he is ill, absent from the country, or otherwise incapacitated, in which case the legal representative or agent may execute the affidavit. A minor, however, making his own return must execute the affidavit.

The oath will be administered without charge by any collector, deputy collector, or internal revenue agent, or (if you are in the military or naval service of the United States) by any military or naval officer who is authorized to administer oaths for purposes of military or naval justice and administration. If an internal revenue officer is not available, the return should be sworn to before a notary public, justice of the peace, or other person authorized to administer oaths.

10. WHEN AND WHERE THE RETURN MUST BE FILED.

If the return is for the calendar year 1921, file it with the Collector of Internal Revenue for the district in which you live or have your principal place of business on or before March 15, 1922. If for a period other than the calendar year, the return should be filed on or before the 15th day of the third month following the close of such period.

In case the taxpayer had no legal residence or place of business in the United States, the return should be forwarded to the Collector of Internal Revenue, Baltimore, Md.

If the address of the collector is not printed on the return and you do not know it, ask at the post office or bank.

11. WHEN AND TO WHOM THE TAX MUST BE PAID.

The tax should be paid, if possible, by sending or bringing with the return a check or money order drawn to the order of "Collector of Internal Revenue at (insert name of city and State)."

Do not send cash through the mail, nor pay it in person, except at the office of the Collector.

The tax may be paid in four equal installments, as follows:

The first installment shall be paid at the time fixed by law for filing the return, the second installment shall be paid on the 15th day of the third month, the third installment on the 15th day of the sixth month, and the fourth installment on the 15th day of the ninth month, after the time fixed by law for filing the return.

The total tax may be paid at the time of filing the return, or if not so paid, one installment must be paid and the balance may be paid in installments, or in full, on or prior to any subsequent installment date referred to above. Failure to pay any installment on the date fixed by law makes the taxpayer liable for the payment of the balance of tax due upon notice and demand by the Collector.

12. PENALTIES.

For Making False or Fraudulent Return.

Not exceeding $10,000 or not exceeding one year's imprisonment, or both, in the discretion of the court, and, in addition, 50 per centum of the total tax evaded.

For Failing to Make Return on Time.

Not more than $1,000, and, in addition, 25 per centum of the total amount of the tax.

For Failing to Pay Tax When Due, or Understatement of Tax Through Negligence, etc.

Five per centum of the tax due but unpaid, plus interest at the rate of 1 per centum per month during the period in which it remains unpaid.

6. TABLES OF SURTAX AND INSTRUCTIONS FOR CALCULATION.

SURTAX RATES.

Amount of Net Income	Rate	Total Surtax on Each Amount	Amount of Net Income	Rate	Total Surtax on Each Amount
A	B	C	A	B	C
$5,000			$60,000	28%	$8,110
6,000	1%	$10	62,000	29%	8,690
8,000	2%	50	64,000	30%	9,290
10,000	3%	110	66,000	31%	9,910
12,000	4%	190	68,000	32%	10,550
14,000	5%	290	70,000	33%	11,210
16,000	6%	410	72,000	34%	11,890
18,000	7%	550	74,000	35%	12,590
20,000	8%	710	76,000	36%	13,310
22,000	9%	890	78,000	37%	14,050
24,000	10%	1,090	80,000	38%	14,810
26,000	11%	1,310	82,000	39%	15,590
28,000	12%	1,550	84,000	40%	16,390
30,000	13%	1,810	86,000	41%	17,210
32,000	14%	2,090	88,000	42%	18,050
34,000	15%	2,390	90,000	43%	18,910
36,000	16%	2,710	92,000	44%	19,790
38,000	17%	3,050	94,000	45%	20,690
40,000	18%	3,410	96,000	46%	21,610
42,000	19%	3,790	98,000	47%	22,550
44,000	20%	4,190	100,000	48%	23,510
46,000	21%	4,610	150,000	52%	49,510
48,000	22%	5,050	200,000	56%	77,510
50,000	23%	5,510	300,000	60%	137,510
52,000	24%	5,990	500,000	63%	263,510
54,000	25%	6,490	1,000,000	64%	583,510
56,000	26%	7,010	1,000,000+	65%	
58,000	27%	7,550			

INSTRUCTIONS.

To compute the amount of surtax on any amount of net income in excess of $5,000—

First. Find in column A the largest sum which is less than the total amount of the net income subject to surtax (Item 19 or Item 20, page 1 of the return).

Second. Find in column C the corresponding amount of total surtax.

Third. To the amount of surtax found as above add an amount computed as follows. Subtract from the net income the sum found in column A and multiply the remainder by the rate shown on the next line below in column B.

The sum of these two amounts is the total surtax due.

In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, the surtax on the profit shall not exceed 20 per centum of the selling price as provided by Section 211 (b) of the Revenue Act of 1921.

CALCULATION OF SURTAX.

1. ITEM	2. Example Net income $13,800	3. Computation of surtax on Item 20, page 1, of the return	
1. Largest sum in column A which is less than the total amount of the net income	$12,000.00	$	
2. Total surtax thereon shown in column C	190.00		
3. Remainder of net income after subtracting Item 1, above	1,800.00		
4. Surtax on this remainder at rate shown in column B on line below that from which Item 1 was taken	90.00		
5. Total surtax due (sum of Items 2 and 4) (Enter as Item 30, page 1 of the return)	280.00	$	

13. INCOME FROM SALARIES, WAGES, COMMISSIONS, ETC.

Report all [illegible] received from [illegible] outside sources, and [illegible] reported as [illegible] in Item 5 for [illegible] (b) your wife [illegible] husband, if a joint return [illegible] each dependent minor [illegible] not [illegible] giving the information requested.

Any amount claimed as a deduction for necessary expenses against salaries, etc., should be fully explained in Schedule F, page 2 of the return, or in an attached statement.

Traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business are deductible.

14. INCOME FROM PARTNERSHIPS, FIDUCIARIES, ETC.

Report your share (whether received or not) in the profits of a partnership or personal service corporation, or in the income of an estate or trust, except the part of such share that consisted of dividends on stock of domestic corporations, and taxable interest on obligations of the United States, which should be included in Items 8, 9, and 10, at foot of page 2 of the return.

Report in Item 1, salary received from a partnership or personal service corporation.

If the taxable period on the basis of which you file your return fails to coincide with the annual accounting period of the partnership, personal service corporation, or fiduciary, then you should include in your return your distributive share of the total net income for such accounting period, ending within your taxable period.

15. INCOME FROM RENTS AND ROYALTIES.

If you received property or crops in lieu of cash rent, report the income as though the rent had been received in cash. Crops received as rent on a crop-share basis should be reported as income for the year in which disposed of (unless your return shows income accrued).

Explain in Schedule A, repairs, depreciation, depletion, and other expenses. Other expenses include interest, taxes, fire insurance, fuel, light, labor, and other necessary expenses of this character.

16. INCOME FROM BUSINESS OR PROFESSION.

Report in Item 5 income from—

(a) Sale of merchandise, or of products of manufacturing, construction, mining, and agriculture.

(b) Business service, such as transportation, storage, laundering, hotel and restaurant service, livery and garage service, etc., if you owned the business. If you are only an employee of a business, report your salary or wages in Item 1.

(c) A profession, such as medicine, law, or dentistry, if you practiced it on your own account. If you were employed on a salary, report your salary in Item 1.

In general, report in Item 5, any income in the earning of which you incurred expenses for labor, rent, etc.

If you are a farmer (or a farm owner renting your farm to another person on shares), see Instruction 7.

Describe the business or profession, as "grocery," "retail clothing," "drug store," "laundry," "doctor," "lawyer," "farmer," etc.

Report the total income derived from sales or from services less any discounts or allowances from the sale price or service charge. (For installment sales see Instruction 5.)

"Total Business Expenses" include: (1) cost of goods sold, which is usually obtained by adding to the inventory at the beginning of the year the merchandise and supplies purchased during the year, and deducting from this sum the inventory at the end of the year, (2) business expenses, which include all ordinary and necessary business expenses not classified above, such as office wages, rent, heat, light, and traveling expenses (see Instruction 13), (3) repairs, wear and tear, obsolescence, depletion, and property losses (other than merchandise), such as (a) ordinary repairs required to keep property in usable condition, (b) reasonable allowance for exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence, and (c) losses of business property by fire, storm, or other casualty, or theft, not compensated for by insurance or otherwise and not made good by repairs claimed as deductions; and (4) bad debts, or portions thereof, arising from sales or professional services that have been reported as income, which have been definitely ascertained to be worthless and charged off within the year, or such reasonable amount as has been added to a reserve for bad debts within the year. A debt previously charged off as bad, if subsequently collected, must be returned as income for the year in which collected. Explain these deductions under Schedule B, page 2 of the return.

Do not include cost of business equipment or furniture, expenditures for replacements or for permanent improvements to property, or personal living or family expenses, nor any deduction for depreciation in the value of a building occupied by you as a dwelling, or of other property held for personal use.

If Item 5 shows a deficit, indicate by using red ink or a minus sign.

17. PROFIT FROM SALE OF REAL ESTATE.

Describe the property briefly, as "farm," "house," "lot."

State the actual consideration or price received, or, in case of an exchange, the fair market value of the property received.

Enter the cost [illegible], and if it was acquired prior to March 1, 1913, the fair market value on that date. Attach statement explaining how value at March 1, 1913, was determined. Expenses incidental to the purchase may be included in the cost if never claimed in income tax returns as deductions from income.

Enter as depreciation the amount of wear and tear and obsolescence, or depletion, sustained since March 1, 1913 (or since date of acquisition, if subsequent to March 1, 1913).

In case the property was acquired by gift, bequest, devise, or inheritance after March 1, 1913, or in any manner prior to that date, see Section 202 of the Revenue Act of 1921.

If the net result to be entered in Item 6 is a deductible loss, indicate the deficit by using red ink or a minus sign.

18. PROFIT FROM SALE OF STOCKS, BONDS, ETC.

The method of computation and the information to be submitted in the case of sales of stocks, bonds, etc., is similar to that required for Item 6, except that subsequent improvements and depreciation are not involved. The profit (or loss) should be computed in accordance with Instruction 17 above.

19. OTHER INCOME.

Report all other taxable income for which no place is provided elsewhere on page 1 of the return, including dividends received on stock of foreign corporations. Dividends received on stock of domestic corporations and taxable interest on obligations of the United States should be reported in Items 8, 9, and 10 at the foot of page 2 of the return.

20. INTEREST PAID.

Enter as Item 10 interest paid on personal indebtedness as distinguished from business indebtedness (which should be deducted under Schedules A, B, C, or D). Do not include interest on indebtedness incurred for the purchase of bonds and other obligations, the interest on which is exempt from tax, except interest on indebtedness incurred to purchase or carry obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer.

21. TAXES PAID.

Enter as Item 11 personal taxes paid and all taxes on property not used in business or profession, not including those assessed against local benefits of a kind tending to increase the value of the property. Do not include Federal income taxes, taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer, nor income and profits taxes claimed as a credit in Item [illegible], page 1 of the return.

22. LOSSES BY FIRE, STORM, ETC.

Enter as Item 12 losses of property not connected with your trade, business, or profession, sustained during the year from fire, storm, shipwreck, or other casualty, or from theft, which were not compensated for by insurance or otherwise. (Losses claimed should be explained in Schedule E, on page 2 of the return.)

Do not deduct losses incurred in transactions which were neither connected with your trade or business, nor entered into for profit.

23. CONTRIBUTIONS.

Enter as Item 13 contributions or gifts made within the taxable period to or for the use of (a) the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes, (b) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the Women's Auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or (c) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph.

Fiduciaries filing this return for estates in the process of administration are allowed, in lieu of this deduction, that provided in Section 219 [illegible] of the Revenue Act of 1921. List names of organizations and amounts contributed to each in Schedule F.

24. BAD DEBTS.

Enter as Item 14 all bad debts other than those claimed as a deduction in Items above. State in Schedule F (a) of what the debts consisted, (b) when they were created, (c) when they became due, and (d) how they were actually determined to be worthless.

25. OTHER AUTHORIZED DEDUCTIONS.

If this return is filed for an estate in the process of administration, there may be deducted the amount of any income properly paid or credited to beneficiaries. Any deduction claimed in Item 15 should be explained in Schedule F.

DETACH AND RETAIN THIS INSTRUCTION SHEET WITH YOUR WORKING PAPERS.

Form 1122—UNITED STATES INTERNAL REVENUE SERVICE

INFORMATION RETURN OF SUBSIDIARY OR AFFILIATED CORPORATION

WHOSE NET INCOME AND INVESTED CAPITAL ARE INCLUDED IN RETURN OF A PARENT OR PRINCIPAL REPORTING CORPORATION FOR PURPOSES OF INCOME AND PROFITS TAXES

FOR CALENDAR YEAR 1921

If return is for calendar year 1921, file it on or before March 15, 1922, with the Collector of Internal Revenue for the District in which the Subsidiary or Affiliated Corporation has its principal office.

If for a period other than a calendar year, the return should be filed on or before the 15th day of the third month following the close of such period.

Or for period begun ____________, 1920, and ended ____________, 1921

(Date Received)

____
(Name)

____
(Street and number or rural route)

____
(Post Office and State)

1. Date incorporated ____________ Under laws of what State? ____________

2. Kind of business ____________

3. Par value of capital stock outstanding at beginning of taxable period:

(*a*) Common, $____________; (*b*) preferred, $____________

4. Name of parent corporation ____________

5. Address of parent corporation ____________

6. Internal revenue district in which consolidated return has been filed ____________
(Give district, or city and State)

7. The department prefers that the entire tax shown on a consolidated return be paid by the parent or principal reporting corporation, instead of being apportioned among the corporations composing the affiliated group.

If apportionment is made, state the amount of income and profits taxes for the taxable period to be assessed against the subsidiary or affiliated corporation making this return ____________ $____________

We, the undersigned president and treasurer of the above-named subsidiary or affiliated corporation, being severally duly sworn, each for himself deposes and says that the foregoing return, including the accompanying list (if any), has been examined by him and is to the best of his knowledge and belief a true and complete return of information made in good faith pursuant to the Revenue Act of 1921 and the Regulations issued thereunder.

SWORN to and subscribed before me this

______ day of ____________, 1922. ____________ *President.*

____
(Signature of officer administering oath.)

______________________________ ____________ *Treasurer.*
—11645 (Title)

Form 1065
U. S. Internal Revenue

PARTNERSHIP AND PERSONAL SERVICE CORPORATION RETURN OF INCOME

FOR CALENDAR YEAR 1921

Do not write in this space

Examined by ....

Date received

THIS RETURN SHOULD BE FILED NOT LATER THAN THE 15TH DAY OF THE THIRD MONTH FOLLOWING THE CLOSE OF THE ACCOUNTING PERIOD

Or for period begun ...., 1920, and ended ...., 1921

PRINT NAME AND ADDRESS PLAINLY BELOW

.... (Name)

.... (Street and number)

.... (Post office and State)

KIND OF BUSINESS .... STATE WHETHER PARTNERSHIP OR CORPORATION ....

SCHEDULE A—INCOME TO BE ACCOUNTED FOR BY MEMBERS.

GROSS INCOME

1. Gross sales, less returns and allowances	$		
2. Less cost of goods sold, exclusive of items called for separately below (attach Schedule A2)		$	
3. Gross income from services or operations other than trading or manufacturing, less allowances (attach Schedule A3)			
4. Taxable interest from all other sources (not including interest referred to under Items 2 and 3, Schedule C)			
5. Rents			
6. Royalties			
7. Share of net income earned by a partnership or personal service corporation (whether received or not)			
8. Dividends subject to surtax only (attach Schedule A8)			
9. Dividends subject to both normal and surtax (attach Schedule A9)			
10. Other income (not including any amount reported in Item 23 below nor interest on Liberty Bonds) (attach Schedule A10)			
11. Total of Items 1 to 10			$

DEDUCTIONS

12. Expenses (except amounts reported in Item 2 above, or called for separately below) (attach Schedule A12)	$	
13. Compensation of partners or stockholders in whatever form paid (attach Schedule A13)		
14. Repairs (including labor, supplies, etc.) (attach Schedule A14)		
15. Interest (attach Schedule A15)		
16. Taxes (attach Schedule A16)		
17. Bad debts (attach Schedule A17)		
18. Exhaustion, wear and tear (including obsolescence) (attach Schedule A18)		
19. Depletion (attach Schedule A19)		
20. Amortization of War facilities (attach Schedule A20)		
21. Total of Items 12 to 20		$
22. Item 11 minus Item 21		$
23. Profit or loss on sales of capital assets and miscellaneous investments (attach Schedule A23)	$	
24. Losses sustained by fire, storm, etc. (attach Schedule A24). Extend difference between the sums of Items 23 and 24		
25. Net Income to be Accounted for by Members (Item 22 minus Item 24 extended)		$

SCHEDULE B—PARTNERS' OR STOCKHOLDERS' SHARES OF INCOME AND CREDITS.

Enter below the share of net income (whether distributed or not) of each member of the partnership or stockholder of the personal service corporation (except interest on obligations of the United States), each partner's or stockholder's share of any income tax paid at source on tax-free covenant bonds, and any income and profits taxes paid by the partnership or corporation to a foreign country or to a possession of the United States. (See page 1 of Instructions, paragraphs 9 to 14, inclusive.)

If the distributable interests in the net income are determined on a basis other than a percentage basis, attach an explanatory statement.

Members of Partnership or Stockholders of Personal Service Corporation

1. Name and address of each, as shown on individual tax returns	2. Interest in partnership or per cent of shares held	3. Dividends subject to surtax only	4. Other Income (Item 25 minus Item 8)	5. Tax Paid at Source on Tax-free Covenant Bonds	6. Income and Profits Taxes Paid to a Foreign Country or to a Possession of the United States
(a)		$	$	$	$
(b)					
(c)					
(d)					
(e)					
(f)					
(g)					
(h)					
(i)					
(j)					
(k) Totals		$	$	$	$

The undersigned, being severally duly sworn, each for himself deposes and says that this return, including the accompanying schedules and statements, has been examined by him and is to the best of his knowledge and belief a true and complete return, made in good faith, for the accounting period as stated, pursuant to the Revenue Act of 1921 and the Regulations issued under the authority thereof.

Sworn to and subscribed before me this .... day of ...., 1922

Seal of officer making affidavit.

.... (Signature of officer administering oath)

.... (Official capacity)

President of corporation
Member of partnership

Treasurer of corporation

(An amended return must be plainly marked "Amended" across the face of the return.)

SCHEDULE C—RECONCILIATION OF NET INCOME AND ANALYSIS OF CHANGES IN SURPLUS.

1 Net income from Schedule A, Item [illegible]	$			
2 Interest on obligations [illegible] issued since September 1, 1917 (except Victory Liberty Loan 3¾% Notes)				
3 Income not to be reported for tax purposes:				
(a) Interest on obligations of the United States issued before September 1, 1917, Victory Liberty Loan 3¾% Notes, and obligations of United States possessions				
(b) Interest on obligations of States, Territories, and political subdivisions thereof				
(c) Interest on Farm Loan Bonds issued under Federal Farm Loan Act				
(d) Dividends from stock of personal service corporations from [illegible] [illegible] period between January 1, 1918, and the [illegible] period				
(e) [illegible] (to be detailed)				
4 Charges against reserve for bad debts if Item 17, Schedule A, is not an addition to reserve				
5 Charges against reserves for contingencies, etc. (to be detailed)				
(a)				
(b)				
(c)				
6 Total of Items 1 [illegible]	$			
7 Total from Item 17				
8 Net profit for period as shown by books, before any adjustments are made thereto (Item 6 minus Item 7)	$			
9 Surplus and undivided profits as shown by balance sheet at close of preceding accounting period				
10 Other credits to surplus (to be detailed)				
(a)				
(b)				
11 Total of Items 8 to 10, inclusive	$			
12 Total from 18				
13 Surplus and undivided profits as shown by balance sheet at close of accounting period (Item 11 minus Item 12)	$			

14 Unallowable deductions:				
(a) Donations, gratuities, and contributions	$			
(b) Income and profits taxes paid to the United States, its possessions or a foreign country				
(c) Special improvement taxes tending to increase the value of the property assessed				
(d) Furniture and fixtures, additions, or betterments treated as expenses on the books				
(e) Replacements or renewals				
(f) Insurance premiums paid on the life of any officer or employee for the benefit of the corporation or business				
(g) Interest on indebtedness incurred for the purchase of bonds and other obligations the interest on which is wholly exempt from tax, except interest on indebtedness incurred to purchase or carry Victory Liberty Loan 3¾% Notes originally subscribed for by the taxpayer				
(h) Additions to reserve for bad debts which are not included in Item 17, Schedule A				
(i) Additions to sinking fund reserve and other contingencies (to be detailed)				
(1)				
(2)				
(3)				
(j) Other unallowable deductions (to be detailed)				
(1)				
(2)				
(3)				
15 Total of Item 14	$			
16 Dividends or withdrawals (state whether paid in cash, stock of the company, or other property):				
(a) Date paid .... Character	$			
(b) Date paid .... Character				
(c) Date paid .... Character				
(d) Date paid .... Character				
17 Other debits to surplus (to be detailed)				
(a)				
(b)				
18 Total of Items 15 and 17	$			

SCHEDULE D—BALANCE SHEETS.

Attach hereto balance sheets as at the beginning and end of the accounting period (preferably in parallel columns) showing as nearly as practicable the details called for below. (These balance sheets should be prepared from the books and should be in agreement therewith, or any differences should be reconciled.)

ASSETS.

Cash (including cash in bank and on hand, certificates of deposit, etc.)
Trade accounts (before deducting reserves for losses)
Notes receivable from customers
Other accounts and notes receivable (to be classified)
Inventories.
Raw materials
Work in progress
Finished products
Supplies
Investments.
Bonds—
(a) Bonds and obligations of (issue to be stated separately)
Exempt municipal, State, etc.
Other
Stock of corporations—
Foreign
Domestic
Loans and advances.
To members and employees
To others.
Deferred charges to future operations (to be detailed)

ASSETS (continued).

Fixed assets
Land
Buildings
Machinery
Tools and minor equipment
Delivery equipment
Office furniture
Other (to be characterized)
Total
Less reserves for depreciation and depletion (show separately amount applicable to each fixed asset) *
Net Value
Patents, good will, and other intangible assets
Paid for in cash or other tangible property
Paid for in stock (other than stock dividends) or in shares of a partnership
Created by stock dividend, or otherwise
Discount
On bonds
On stock
Total.

LIABILITIES

Loans and notes payable
To members
To others (including bank loans)
Accounts payable
Trade
Other
Accrued expenses and reserves, the charges creating which are allowable deductions from income (to be detailed)
Reserves, the charges creating which are not allowable deductions from income (to be detailed)
Reserves for losses on notes and accounts receivable
Other reserves (to be detailed)
Capital stock outstanding (to be classified) or (if partners' capital and current accounts (to be detailed)
Surplus and undivided profits.
Total

* Reserves for depreciation may be deducted from the respective asset accounts or itemized on the liability side of the balance sheet.

QUESTIONS.

KIND OF BUSINESS.

1 By means of the key letters given below, identify the corporation's main income producing activity with one of the general classes and follow this by a special description of the business sufficient to give the information called for under each general class.

A—Agriculture and related industries including fishing, logging, ice harvesting, etc., and also the leasing of such property. State the product or products. B—Mining and quarrying, including gas and oil wells, and also the leasing of such property. State the product or products. C—Manufacturing. State the product and also the material if not implied by the name of the product. D—Construction, excavations, buildings, bridges, railroads, ships, etc., also equipping and installing same with systems, devices, or machinery without their own fixture. State nature of structures built, materials used or kind of installations. E1—Transportation (rail, water, local, etc.). State the kind and special product transported, if any. E2—Public utilities: gas (natural or coal or water), electric light or power (hydro or steam generated), heating (steam or hot water), telephone, waterworks, or power. E3—Storage without trading or profit from sales (elevator, warehouses, stockyards, etc.). State product stored. E4—Leasing transportation or utilities. State kind of property. F—Trading in goods bought and not produced by the trading concern. State manner of trade whether wholesale, retail or commission, and the product handled. Sole with storage with profit primarily from sales. G—Service—domestic, including hotels, restaurants, etc., amusements, other professional, personal or technical service. State the service. H—Finance, including banking, real estate, insurance. I—Concerns not falling in above classes, or concerns of combining several of them with no predominant business. (State kind of business or other reasons.)

2 Concerns whose business involves activity falling in two or more of the above general classes, where the same product is concerned, should report business as identified with but one of the above general classes, for example: concerns in A or B which also transport and market their own product exclusively or mainly, should state the business identified with class A or B; concerns in C manufacturing, which own or control their source of material supply in A or B and which also transport, sell, or install their own product exclusively or mainly, should be identified with manufacturing; concerns in D may control or own source of supply of materials used extensively or mainly in their constructive work; concerns in E1 or E2 may own or control the source of their material or power; concerns in F may transport or store their own merchandise, but its production would identify them with A, B or C.

3 Answer:

(a) General class (use key letter designation) ....

(b) Main income producing business. Give specifically the information called for under each key letter, also whether acting as principal or as agent on commission. State if inactive or in liquidation.

....

4 A personal service corporation must explain its business in order to determine whether it is to be classed as such. If the character of the business is different from that carried on during the preceding accounting period the nature of the change must be explained. Where necessary, the statement should be made on a separate sheet which should be firmly attached to this return.

OTHER CORPORATIONS IN SAME BUSINESS.

5 Attach hereto a list of the names and addresses of five representative corporations in your locality or section of the country engaged in the same kind of business.

ORGANIZATION OR INCORPORATION

6 Date of organization or incorporation ....

7 If incorporated, under the laws of what State? ....

8 Is the corporation a successor to or was it formed to take over or conduct part of the business of another corporation? .... If so, state name and address of predecessor or other organization, and, in the latter case, the financial, managerial, and contractual relationships existing between yourselves and the other organization ....

VALUATIONS OF CAPITAL STOCK.

9 What was the fair value of the total capital stock of the corporation as determined in the last assessment, if any, of the capital stock tax? ....

Date of that assessment ....

AFFILIATIONS WITH CORPORATIONS

10 Does the corporation own directly or control through closely affiliated interests or by a nominee or nominees over 95 per cent of the outstanding voting capital stock of another corporation? ....

11 Is over 95 per cent of your voting capital stock owned by another corporation or by two or more corporations that are affiliated? ....

12 Is over 95 per cent of your voting capital stock as well as over 95 per cent of the voting capital stock of another corporation or other corporations owned or controlled by the same individual or partnership or by the same individuals or partnership? ....

13 If the answer to questions 10, 11 and 12 or any of them is "yes," the following information should be furnished as at the beginning of the accounting period, indicating any substantial changes during such period:

Name of Shareholder	(Name of corporation.) (Address.) Shares held.	Percentage of stockholdings.	(Name of corporation.) (Address.) Shares held.	Percentage of stockholding.
Total				
Shares outstanding beginning of year				
Shares outstanding end of year				

(a) Separate statements should be submitted for common and preferred stock, indicating (1) whether it had full voting privileges during the entire accounting period, (2) whether the voting privileges were cumulative, (3) whether these voting privileges were exercised during the accounting period, (4) the conditions by which these voting privileges may be sacrificed or acquired.

(b) State the dividend privileges of the respective classes of stock, the rate of dividends paid during the accounting period, the date and rate of last dividend payment, and whether, and under what conditions, the preferred stock participates in the earnings above the fixed dividend rate.

(c) State if the preferred stock has preference in respect to distribution of assets, dividends or otherwise.

(d) Show separately the number of shares of each class held by the respective stockholders of each company, except where impracticable by reason of the large number of stockholders. Under such conditions show only those holding stock in two or more of the affiliated corporations.

(e) Indicate whether any of the stock was held during the accounting period conditionally or by agreement, expressed or implied, and state whether such arrangements are considered valid, giving supporting reasons.

(f) Indicate whether any stock is held by employees or officers and state their relationship to the corporation and the conditions, either expressed or implied, under which such stock was acquired and was held during the accounting period. Also submit the following information in respect to such stockholders as at the date of acquisition: (1) Par value of stock, (2) book value of stock, (3) market value of stock, (4) consideration or amount paid for such stock, (5) method of payment for such stock.

(g) If the stock in any one or more of the corporations is held by members of one family, or related families, state the relations existing between the various stockholders and whether such stock was acquired by gift, purchase, or otherwise.

(h) Explain fully the nature and extent of any intercompany transactions or arrangement which may effect an arbitrary distribution of profits or assign to any one of the affiliated corporations a disproportionate share of net income or invested capital.

Foreign corporations may not be included in consolidation.

GOVERNMENT CONTRACTS.

14 Have any adjustments during the accounting period been made on account of contract or contracts with the Government or its agencies or from any Government contract or contracts from which you derived income directly or indirectly, through the operations of a claim board or otherwise? (Answer "Yes" or "No.") ....

If so, state the amounts involved, $.........., whether or not such amounts are included in this return.........., and, if not, was an amended return accounting for the additional income filed for accounting period in which the contract was terminated? .... Submit a schedule showing full particulars of the contract, date entered into, date the work ceased under said contract or contracts, and the amount and nature of the adjustment.

AMORTIZATION.

15 Has amortization been claimed? (Answer "Yes" or "No.") .... If so, for what year .... Amount $..........

LIST OF ATTACHED SCHEDULES

16 Attach a list of schedules accompanying this return, giving for each a brief title and a schedule number (see paragraph at top of page 1 of instructions).

8—11343

GENERAL INSTRUCTIONS.

Partnership and Personal Service Corporation Return of Income.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS REQUIRED TO MAKE A RETURN OF INCOME.

1. *Partnerships.*—Every partnership, whether domestic or foreign, doing business in the United States must make a return of income on this form regardless of the amount of its gross or net income. (See Sections 218 and 224 of Revenue Act of 1921.)

2. *Personal service corporations.*—Every personal service corporation must make a return of income on this form regardless of the amount of its gross or net income. (See Section 218 of Revenue Act of 1921.)

3. *Personal service corporation defined.*—The term "personal service corporation", means a corporation, not expressly excluded, the income of which is derived from a profession or business (*a*) which consists principally of rendering personal service, (*b*) the earnings of which are to be ascribed primarily to the activities of the principal owners or stockholders, and (*c*) in which the employment of capital is not necessary or is only incidental. (See Section 200, paragraph 5, Revenue Act of 1921.)

4. *Corporations excluded.*—The following classes of corporations are expressly excluded from classification as personal service corporations: (*a*) Foreign corporations; (*b*) corporations 50 per cent or more of whose gross income consists of gains, profits, or income derived from trading as a principal; and (*c*) corporations 50 per cent or more of whose gross income consists of gains, profits, commissions, or other income derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, inclusive.

A corporation is not a personal service corporation merely because less than 50 per cent of its gross income was derived from trading as a principal or from Government contracts. A corporation can not be considered a personal service corporation when another corporation owns or controls substantially all of its stock, or when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise is owned or controlled by the same interests. (See Sections 200 and 240 of the Revenue Act of 1921.)

5. *More than one business.*—A corporation engaged in two or more professions or businesses which are more or less related, one of which does not consist of rendering personal service, is not a personal service corporation unless the nonpersonal service element is negligible or merely incidental and no appreciable part of its earnings are to be ascribed to such sources. (See also Section 303 of the Revenue Act of 1921.)

6. *Activities of stockholders.*—In determining whether a corporation is a personal service corporation, no weight can be given to the fact that it renders personal services unless (*a*) the principal owners or stockholders are regularly engaged in the active conduct of its affairs, and are engaged in such a manner that the earnings are to be ascribed primarily to their activities, and (*b*) its affairs are conducted principally by such owners or stockholders. If employees contribute substantially to the services rendered by a corporation, it is not a personal service corporation unless in every case in which services are so rendered the value of and the compensation charged for such services are to be attributed primarily to the experience or skill of the principal owners or stockholders.

7. *Stock interest of active members.*—No corporation or its owners or stockholders shall make a return in the first instance on the basis of its being a personal service corporation unless at least 80 per cent of its stock is held by those regularly engaged in the active conduct of its affairs.

8. *Capital.*—In determining whether a corporation is a personal service corporation, no weight can be given to the fact that the invested capital of the corporation under Title III of the Act or the actual investment of the principal owners or stockholders is comparatively small. If the use of capital is necessary or more than incidental, capital is a material income-producing factor and the corporation is not a personal service corporation.

INSTRUCTIONS FOR FILLING IN SCHEDULE B, PAGE 1.

9. This Schedule is to be used for showing the share of each partner or stockholder in the income of the partnership or personal service corporation, whether distributed or not. Where the ownership of a personal service corporation has changed during the accounting period, the distributed portion of the net income is taxable to the recipients, while the undistributed portion is taxable to the owners as at the end of the accounting period.

10. Enter on lines (*a*), (*b*), (*c*), etc., the proportionate amount of the totals shown in columns 3 and 4 to which each individual partner or stockholder is entitled, whether distributed or not. If the amount to be entered in column 4 is a loss, the amount should be indicated by red ink or a minus sign.

11. If the partnership or personal service corporation received directly or through another partnership, personal service corporation, or a fiduciary, interest on corporation bonds containing a clause by which the debtor corporation agrees to pay the interest without any deduction for taxes, and there were filed with such interest coupons a white certificate, Form 1000, not claiming exemption, a tax of 2 per cent was paid at the source, and this tax should be allocated to the members or stockholders in column 5.

12. If any amount is entered in column 6, a copy of Form 1116, completely filled in and sworn to or affirmed, must be submitted with this return. If such taxes have been paid, Form 1116 must have attached to it the receipt or other evidence of each such tax payment. If such taxes have been accrued, Form 1116 must have attached to it a copy of the return on which each such accrued tax was based, or other evidence as to the accrual of taxes.

13. When a credit is claimed on Form 1040 or Form 1040A for accrued taxes, the Commissioner may, as a condition precedent to the allowance of such credit, require the taxpayer to give a bond (Form 1117), with sureties satisfactory to and to be approved by him, in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due if the taxes when paid differ from the amount claimed in respect thereof.

INTEREST ON LIBERTY BONDS, ETC.

14. In case the partnership or personal service corporation owned Liberty Bonds or other obligations of the United States issued since September 1, 1917 (except Victory Liberty Loan 3¾% Notes, and postal saving certificates of deposit), or a share of these obligations held by another partnership, personal service corporation, or a fiduciary, the partnership or personal service corporation should advise each partner or stockholder as to his proportionate amount of these obligations and the interest thereon, in order that the partner or stockholder may determine whether the interest is taxable on his individual income-tax return.

PERIOD COVERED.

15. The accounting period is the calendar year ending December 31, 1921, or the fiscal year ending on the last day of any month other than December in the calendar year 1921. The accounting period established for the year immediately preceding must be adhered to, unless permission was received from the Commissioner to make a change.

16. If a partnership or corporation changes its accounting period, it shall as soon as possible give to the collector for transmission to the Commissioner written notice of such change and of its reasons therefor. Upon approval by the Commissioner, the taxpayer shall thereafter make his returns upon the basis of the new accounting period. (See Sections 212 (*c*) and 226, Revenue Act of 1921.)

TIME AND PLACE FOR FILING.

17. Returns must be sent to the Collector of Internal Revenue for the district in which the partnership's or corporation's principal place of business is located, so as to reach the Collector's office on or before the 15th day of the third month following the close of the accounting period.

SIGNATURES AND VERIFICATION.

18. Returns of partnerships must be sworn to by a member of the partnership. Corporation returns must be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer of the corporation. If receivers, trustees in bankruptcy, or assignees are operating the property or business of the partnership or corporation, such receivers, trustees, or assignees shall execute the return under oath.

PENALTY FOR FAILURE TO FILE RETURN ON TIME.

19. A penalty of not more than $1,000 attaches for failure to file a return within the time required by law. If the failure is willful or an attempt is made to defeat or evade the tax, the penalty is an amount not in excess of $10,000 or imprisonment for not more than one year, or both, together with costs of prosecution.

INFORMATION AT THE SOURCE.

20. Every corporation making payments of salaries, wages, interest, rent, commissions, or other fixed or determinable income of $1,000 or more during the calendar year, to any individual or partnership, is required to make a true and accurate return to the Commissioner of Internal Revenue, showing the nature and source of such payments and the name and address of the recipient. Forms 1096 and 1099, for reporting such information, will be furnished by any collector of internal revenue. Such returns of information covering the calendar year 1921 must be forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., in time to be received not later than March 15, 1922.

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SCHEDULES TO BE FURNISHED IN SUPPORT OF ITEMS IN SCHEDULE A.

The schedules called for below should be prepared and firmly attached to the return. Designate each schedule with the number of the item in Schedule A which it explains. Make schedules on paper of uniform size, so far as practicable, and enter the name and address on each sheet. Attach a list of schedules accompanying the return, giving for each a brief title and schedule number.

SCHEDULE A2: COST OF GOODS SOLD, EXCLUSIVE OF EXPENSES, REPAIRS, AND OTHER ITEMS CALLED FOR SEPARATELY.

If you are engaged in a trade or business in which the production, purchase, or sale of merchandise is an income producing factor, (a) secure from the Collector of Internal Revenue and file as a part of this return **Certificate of Inventory, Form 1126**, and (b) submit a schedule showing—

(1) Cost of merchandise bought for sale.
(2) Cost of manufacturing or otherwise producing goods. (List principal items of cost, grouping minor items in one amount.)
(3) Plus inventory at beginning of year.
(4) Total of Items 1 to 3, inclusive.
(5) Less inventory at end of year.
(6) Cost of goods sold, Item 4 minus Item 5.

SCHEDULE A3: GROSS INCOME FROM SERVICES OR OPERATIONS OTHER THAN TRADING OR MANUFACTURING, LESS ALLOWANCES.

Submit a schedule showing the nature and amount of the principal items included herein, the minor items being grouped in one amount.

SCHEDULE A8: DIVIDENDS SUBJECT TO SURTAX ONLY.

Submit a schedule showing the amount received as dividends (a) from each domestic corporation other than a corporation entitled to the benefits of Section 262 of the Revenue Act of 1921, or (b) from each foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of Section 217 of the Act.

SCHEDULE A9: DIVIDENDS SUBJECT TO BOTH NORMAL AND SURTAX.

Submit a schedule showing dividends subject to both normal and surtax, whether received from foreign or domestic corporations, and which are not allowed as a credit under Section 216 of the Revenue Act of 1921.

SCHEDULE A10: OTHER INCOME (not including any amount with respect to sales of capital assets or miscellaneous investments nor interest on Liberty Bonds).

Submit a schedule showing the source, nature, and amount of the principal items included herein, the minor items being grouped in one amount.

SCHEDULE A12: ORDINARY AND NECESSARY EXPENSES (except amounts called for separately in Schedule A).

Submit a schedule showing character and amount of the principal items included herein, the minor items being grouped in one amount.

SCHEDULE A13: COMPENSATION OF PARTNERS OR SHAREHOLDERS.

Submit a schedule showing for each member of the partnership or stockholder of the corporation who was performing active service or who received compensation in any form from the partnership or corporation, (a) name, (b) duties, (c) time devoted to such duties, and (d) total compensation for the accounting period. A personal service corporation should also explain fully the manner and degree in which the earnings of the corporation are dependent on the activities of the stockholders.

SCHEDULE A14: REPAIRS (including labor, supplies, overhead, and other items properly chargeable to repairs).

Submit a schedule showing the nature and amount of the principal items included herein, the minor items being grouped in one amount.

Incidental repairs, which do not add to the value or appreciably prolong the life of property, are deductible as expense. Expenditures for new buildings or for permanent improvements or betterments which increase the value of the property are chargeable to capital account. Expenditures for restoring or replacing property are not deductible under this or any other item of the return. Such expenditures are chargeable to capital account or to depreciation reserve, depending on the treatment of depreciation on the books of the taxpayer.

SCHEDULE A15: INTEREST.

Submit a detailed schedule with respect to interest paid or credited to any member. State the character and amount of the principal on which the interest was computed, and whether such principal is evidenced by note or other form of contract. Describe fully.

The amount of interest deductible under Item 15, Schedule A, is the amount of interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred **or continued to purchase or carry obligations or securities (other than obligations of the** United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation.

SCHEDULE A16: TAXES.

Submit a schedule showing the taxes paid or accrued within the taxable year (except income, war-profits and excess-profits taxes imposed by the authority of the United States, the amount of income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States, if taxpayer claims credit under Section 238, Revenue Act of 1921, and taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and taxes imposed upon the taxpayer upon his interest as a shareholder in a corporation which are paid by the corporation without reimbursement from the taxpayer).

SCHEDULE A17: BAD DEBTS.

Submit a schedule showing debts, or portions thereof, arising from sales or professional services that have been reported as income, which have been definitely ascertained to be worthless and charged off within the accounting period, or such reasonable amount as has been added to a reserve for bad debts within the year.

If the amount entered as Item 17, Schedule A, is an addition to a reserve, furnish proof of the reasonableness of the amount. (See Section 234 (a) 5 of the Revenue Act of 1921.)

SCHEDULE A18: EXHAUSTION, WEAR AND TEAR (including obsolescence).

Submit a schedule in columnar form showing for each class of property the following information:

(1) Kind of property (if buildings, state material of which constructed).
(2) Date acquired.
(3) Age when acquired.
(4) Cost, or if acquired prior to March 1, 1913, the fair market value on that date.
(5) Probable life after acquirement.
(6) Amount of depreciation charged off this year.
(7) Total amount of depreciation charged off previous to this year.

The total amount claimed in this schedule should correspond with the figures reflected in the balance sheet.

If obsolescence is a factor in determining your deduction, attach a statement showing the amount claimed for the accounting period and the basis on which computed.

The amount deductible on account of depreciation is an amount charged off which fairly measures the loss during the accounting period in the value of physical property by reason of exhaustion, wear, tear, and obsolescence. Such an amount should be determined on the basis of the cost of the property, or if acquired prior to March 1, 1913, the fair market value on that date and the probable number of years constituting its life. The capital sum to be replaced should be charged off over the probable life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return. Stocks, bonds, and like securities are not subject to exhaustion, wear and tear within the meaning of the law.

SCHEDULE A19: DEPLETION.

If a deduction is claimed on account of depletion, secure from the Collector Form D (minerals), Form E (coal), Form F (miscellaneous nonmetals), Form O (oil and gas), or Form T (timber), fill in and file with return. If complete valuation data has been filed with questionnaire in previous years, then file with this return information necessary to bring your depletion schedule up to date, setting forth in full statement of all transactions bearing on deductions or additions to value of physical assets with explanation of how depletion deduction for the accounting period has been determined. In case of timber this should be done by filling in Form T (timber).

SCHEDULE A20: AMORTIZATION OF WAR FACILITIES.

In case a deduction is claimed on account of amortization, a schedule should be submitted containing the information called for in Guide Form 1007M, which explains in detail the manner in which a claim of this nature should be presented. A copy of this form may be obtained from the Commissioner. (See Section 234 (a) 9 of the Revenue Act of 1921.)

SCHEDULE A23: PROFIT OR LOSS ON SALES OF CAPITAL ASSETS AND MISCELLANEOUS INVESTMENTS.

Submit a schedule in columnar form showing the following information for each asset sold:

(1) Kind of property.
(2) Date acquired.
(3) Sale price.
(4) Cost.
(5) Fair market value on March 1, 1913, if acquired prior to that date.
(6) Cost of subsequent improvements.
(7) Depreciation.
(8) Net profit or loss.
(9) Amount in column 5 which represents good will, if any.

If any of the assets were acquired prior to March 1, 1913, state how the fair market value on that date was determined.

In case of exchange of property, submit evidence substantiating the basis used in arriving at the fair market value of the property received.

SCHEDULE A24: LOSSES SUSTAINED BY FIRE, STORM, ETC.

A schedule similar to the one requested above should be submitted with respect to losses of property arising from fires, storms, shipwreck, or other casualty, or from theft, and not compensated for by insurance or otherwise, except that column 3 should show "Insurance and salvage" instead of "Sale price."

CAPITAL EMPLOYED IN BUSINESS.

If the balance sheet (Schedule D) of a personal service corporation indicates that a substantial amount of capital (invested or borrowed) is employed in the business, submit a statement explaining why the employment of such capital is incidental and not necessary.

WORKING PAPERS.

Every partnership or corporation should preserve, available for inspection by a revenue officer, working papers showing:

1. The balance in each account on the partnership or corporation's books the amounts in which appear in Schedule A.
2. The amounts deducted from or added to such balances on account of each class of nontaxable income, nonallowable deductions, and other adjustments indicated in Schedule A, with a reference to the number of the item in Schedule A which was changed, and what deductions were excluded.
3. The amount of each balance analyzed to show the amount included in each item of Schedule A, with a reference to the number of the item in Schedule A.

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Form 1001 B—Revised—Jan. 1922
U. S. INTERNAL REVENUE

This form will not be accepted unless all information called for is furnished.

STATEMENT OF INCOME RECEIVED BY NONRESIDENT ALIEN FROM SOURCES WITHIN UNITED STATES

PERSONAL EXEMPTION CLAIMED.

FOR CALENDAR YEAR 1921

To be filed with withholding agent by nonresident alien individual owning bonds of a domestic corporation which contain a tax-free covenant clause. The execution of this certificate does not relieve the bond owner from filing ownership certificates required by the regulations.

NAMES MUST BE PRINTED OR WRITTEN PLAINLY

DEBTOR ORGANIZATION.

Name ....

Street ....

City .... State ....

....

This is to certify that the owner of the above-described bonds is a nonresident alien as to the United States and is a subject of the country as stated above, and is entitled to the personal exemption of $1,000 as provided by Section 216 of the Revenue Act of 1921.

SIGNATURE OF OWNER OR AGENT.

....

Address of Agent. ....

....

OWNER OF BONDS.

Name ....

Street ....

City .... State ....

Subject of ....

Bond interest received during calendar year with respect to tax-free covenant bonds issued by above-named corporation .... $..............

All other income from sources in United States .... $..............

Total .... $..............

Personal exemption $1,000.00

NOTE.—For the taxable year 1921 and subsequent years, only $1,000 personal exemption is allowed a nonresident alien individual, whether he is single, married, or the head of a family, and regardless of his nationality. No credit is allowed for dependents.

TO BE FILLED IN BY WITHHOLDING AGENT.

District in which return Form 1013 is filed ....

Amount of tax required to be withheld at source as shown by Form 1013, for 1921. $..............................

To be reduced on account of personal exemption claimed as indicated by this certificate, the items appearing on the following monthly returns, Form 1012:'

Month .... Page .... Amount of tax.... $..............

Month .... Page .... Amount of tax.... ....

Month .... Page .... Amount of tax.... ....

Month .... Page .... Amount of tax.... ....

Total.... $..............

Name of withholding agent..............................

Address..............................

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APPENDIX C

REVENUE ACT OF 1921

APPENDIX C

REVENUE ACT OF 1921

[PUBLIC—No. 98—67TH CONGRESS.]
[H. R. 8245.]

An Act To reduce and equalize taxation, to provide revenue, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I.—GENERAL DEFINITIONS.

SECTION 1. That this Act may be cited as the "Revenue Act of 1921."

SEC. 2. That when used in this Act—

(1) The term "person" includes partnerships and corporations, as well as individuals;

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies;

(3) The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

(4) The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

(5) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia;

(6) The term "Secretary" means the Secretary of the Treasury;

(7) The term "Commissioner" means the Commissioner of Internal Revenue;

(8) The term "collector" means collector of internal revenue;

(9) The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

(10) The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such terms; and

(11) The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a con-

tractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this subdivision, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.

TITLE II.—INCOME TAX.

Part I.—General Provisions.

Definitions

Sec. 200. That when used in this title—

(1) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1921, shall be the calendar year 1921 [1918] or any fiscal year ending during the calendar year 1921;

(2) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

(3) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

(4) The term "paid" for the purposes of the deductions and credits under this title means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212; and

(5) The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Dividends

SEC. 201 (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913, except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.

(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon.

(c) Any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.

(d) A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913.

(e) For the purposes of this Act, a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands.

(f) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding

taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921.

Basis for Determining Gain or Loss

SEC. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(1) In the case of such property, which should be included in the inventory, the basis shall be the last inventory value thereof;

(2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition;

(3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition. The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402.

(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less

than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income.

(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

(d) (1) Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e);

(2) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted.

(3) Where no deduction is allowed for a loss or a part thereof under the provisions of paragraph (5) of subdivision (a) of section 214 and

paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of.

(e) Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis shall be taxable to the extent of the excess.

(f) Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

Inventories

SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Net Losses

SEC. 204. (a) That as used in this section the term "net loss" means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234, as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4)

amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost.

(b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, and to insurance companies subject to the tax imposed by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary.

(d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

FISCAL YEARS 1920-1921 AND 1921-1922.

SEC. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921, which the portion of such period falling within the calendar year 1921 is of the entire period.

Any amount paid before or after the passage of this Act on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1918 shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, the excess shall be credited or refunded in accordance with the provisions of section 252.

(b) If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title (as in force on December 31, 1921) at the rates

for the calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title (as in force on January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922, is of the entire period: *Provided,* That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2).

(c) If a fiscal year of a partnership begins in 1920 and ends in 1921, or begins in 1921 and ends in 1922, then (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.

Capital Gain

SEC. 206. (a) That for the purpose of this title:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;

(3) The term "capital deductions" means such deductions as are allowed under this title for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain as defined in this section;

(4) The term "capital net gain" means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses;

(5) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary

net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

(c) In the case of a partnership or of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections 218 and 219, but at the rates and in the manner provided in subdivision (b) of this section.

Part II.—Individuals.

Normal Tax

Sec. 210. That in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided,* That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

Surtax

Sec. 211. (a) That, in lieu of the tax imposed by section 211 of the Revenue Act of 1918, but in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual—

(1) For the calendar year 1921, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000.

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 but does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000;

(2) For the calendar year 1922 and each calendar year thereafter, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $6,000 and does not exceed $10,000;

2 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

3 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

4 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

5 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

6 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

8 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

9 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

10 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

11 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

12 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

13 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $36,000;

16 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

17 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

18 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

19 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

20 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

21 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

22 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

23 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

24 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

25 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

26 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

27 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

28 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

29 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

30 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

31 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

32 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

33 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

34 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

35 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

36 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

37 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

38 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

39 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

40 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

41 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

42 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

43 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

44 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

45 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

46 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

47 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

48 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

49 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

50 per centum of the amount by which the net income exceeds $200,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, for the calendar year 1921, 20 per centum, and for each calendar year thereafter 16 per centum of the selling price of such property or interest.

Net Income of Individuals Defined

SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(c) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

Gross Income Defined

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts

of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term, or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal saving certificates of deposit) and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any

essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the Government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) The income of a nonresident alien or a foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States;

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;

(10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation;

(12) The receipts of shipowners' mutual protection and indemnity associations, not organized for profit, and no part of that net earnings of which inures to the benefit of any private stockholder or member but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rents.

(c) In the case of a nonresident alien individual, gross income means only the gross income from sources within the United States, determined under the provisions of section 217.

Deductions Allowed Individuals

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable

allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222 (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (d) taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer. For the purpose of this paragraph estate, inheritance, legacy, and succession taxes acrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only if and to the extent that the profit, if such transaction had resulted in a profit, would be taxable under this title. No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alein individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. Losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable

year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deductions shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Act of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of

purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further*, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(11) Contributions or gifts made within the taxable year to or for the use of: (A) The United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (B) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the women's auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (C) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. In case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to community chests, funds or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary;

(12) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of a gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds

or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts.

(b) In the case of a nonresident alien individual, the deductions allowed in subdivision (a), except those allowed in paragraphs (5), (6), and (11), shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary. In the case of a citizen entitled to the benefits of section 262 the deductions shall be the same and shall be determined in the same manner as in the case of a nonresident alien individual.

Items Not Deductible

Sec. 215. (a) That in computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this Act for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.

Credits Allowed Individuals

Sec. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (2) from a foreign corporation when it is shown to the satisfaction of the

Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500, unless the aggregate net income of such husband and wife is in excess of $5,000, in which case the amount of such personal exemption shall be $2,000. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them. In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000;

(d) $400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the personal exemption shall be only $1,000, and he shall not be entitled to the credit provided in subdivision (d).

(f) The credits allowed by subdivisions (c), (d), and (e) of this section shall be determined by the status of the taxpayer on the last day of the period for which the return of income is made; but in the case of an individual who dies during the taxable year, such credits shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the period for which such survivor makes return of income.

Net Income of Nonresident Alien Individuals

SEC. 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:

(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged

in business with the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable;

(2) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section;

(3) Compensation for labor or personal services performed in the United States;

(4) Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits and income from the sale of real property located in the United States.

(b) From the items of gross income specified in subdivision (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in paragraph (1) of subdivision (a);

(2) Dividends other than those derived from sources within the United States as provided in paragraph (2) of subdivision (a);

(3) Compensation for labor or personal service performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located without the United States;

(d) From the items of gross income specified in subdivision (c) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold.

(f) As used in this section the words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged."

(g) A nonresident alien individual or a citizen entitled to the benefits of section 262 shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States in the manner prescribed in this title;

including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits: *Provided*, That the benefit of the credit allowed in subdivision (e) of section 216 may, in the discretion of the Commissioner, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual or foreign trader shall be liable to distraint for the tax.

Partnerships and Personal Service Corporations

SEC. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

(b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(d) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

This subdivision shall not be in effect after December 31, 1921. In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated after December 31, 1920, shall be taxed to the distributees; and the stockholders of record on December 31, 1921, shall be taxed upon their distributive shares of the difference (if any) between such distributive profits and the portion

of the corporation's net income assignable to the calendar year 1921, determined in the manner provided in clause (1) of subdivision (c) of section 205 of this Act.

Estates and Trusts

SEC. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraphs (1), (2), or (3) of subdivision (a) or in any other case within subdivision (a) of this section except paragraph (4) thereof the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid

by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

(e) In the case of an estate or trust the income of which consists both of income of the class described in paragraph (4) of subdivision (a) of this section and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with subdivision (b) and the tax shall be imposed, and shall be paid by the fiduciary in accordance with subdivision (c), except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in paragraph (4) of subdivision (a) which, pursuant to the instrument or order governing the distribution, is distributable during its taxable year to the beneficiaries. In cases under this subdivision there shall be included, as provided in subdivision (d) of this section, in computing the net income of each beneficiary, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable during the taxable year to such beneficiary.

(f) A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.

Evasion of Surtaxes by Incorporation

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year

upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided,* That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Payment of Individual's Tax at Source

SEC. 221. (a) That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by subdivision (a) of section 216) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits and income a tax equal to 8 per centum thereof: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other

similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g) of section 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United States Government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payment made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty is imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

Credit for Taxes in Case of Individuals

SEC. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States, the amount of any such taxes paid during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(5) The above credits shall not be allowed in the case of a citizen entitled to the benefits of section 262; and in no other case shall the amount of credit, taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits.

(d) If the taxpayer makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or part, any such credit which he finds has already been taken by the taxpayer.

Individual Returns

SEC. 223. (a) That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife; and

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.

(b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over—

(1) Each shall make such a return, or

(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income.

(c) If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

Partnership Returns

SEC. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

Fiduciary Returns

SEC. 225. (a) That every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate or trust the net income of which for the taxable year is $1,000 or over; and

(5) Every estate or trust of which any beneficiary is a nonresident alien.

(b) Under such regulations as the Commissioner with the approval

of the Secretary may prescribe a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate or trust for which the return is made, to enable him to make the return, and (2) that the return is to the best of his knowledge and belief, true and correct. Any fiduciary required to make a return under this Act shall be subject to all the provisions of this Act which apply to individuals.

Returns for a Period of Less Than Twelve Months

SEC. 226. (a) That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.

(b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

(c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

Time and Place for Filing Individual, Partnership, and Fiduciary Returns

SEC. 227. (a) That returns (except in the case of nonresident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

Understatement in Returns

SEC. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

Incorporation of Individual or Partnership Business

SEC. 229. That in the case of the organization as a corporation within four months after the passage of this act of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided*, That this section shall not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year: *Provided further*, That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.

PART III.—CORPORATIONS.

Tax on Corporations

SEC. 230. That, in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

Conditional and Other Exemptions of Corporations

SEC. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members

and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the Act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes";

(14) Personal service corporations. This subdivision shall not be in effect after December 31, 1921.

Net Income of Corporations Defined

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.

Gross Income of Corporations Defined

SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 and 217, except that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by sections 243 or 246) in the manner provided in section 217.

Deductions Allowed Corporations

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reason-

able allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, and (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed nor shall such tax be included in the gross income of the obligee. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes. For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a transaction made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall

be computed upon the basis of its fair market price or value as of March 1, 1913;

(5) Debts ascertained to be worthless and charged off within the taxable year (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(6) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, That in the case of such properties acquired prior to March 1, 1913, the

fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further*, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commisioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(10) In the case of insurance companies (other than life insurance companies), in addition to the above (unless otherwise allowed): (A) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (B) the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, this subdivision shall apply only to mutual insurance companies other than life insurance companies;

(11) In the case of corporations (except those taxed under section 243) issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only. This subdivision shall not be in effect after December 31, 1921;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, the amount of premium

deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provision of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax Acts.

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

Items Not Deductible by Corporations

SEC. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

Credits Allowed Corporations

SEC. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 233;

(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and

(c) The amount of ary war-profits and excess-profits taxes imposed

by Act of Congress for the same taxable year. The credit allowed by this subdivision shall be determined as follows:

(1) In the case of a corporation which makes return for a fiscal year beginning in 1920 and ending in 1921, in computing the income tax as provided in subdivision (a) of section 205, the portion of the war-profits and excess-profits tax computed for the entire period under clause (1) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (a) of section 205, and the portion of the war-profits and excess-profits tax computed for the entire period under clause (2) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (2) of subdivision (a) of section 205.

(2) In the case of a corporation which makes return for a fiscal year beginning in 1921 and ending in 1922, in computing the income tax as provided in subdivision (b) of section 205, the war-profits and excess-profits tax computed under subdivision (b) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (b) of section 205.

Payment of Corporation Income Tax at Source

SEC. 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided*, That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

Credit for Taxes in Case of Corporations

SEC. 238. (a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States: *Provided*, That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year. In the case of domestic insurance companies subject to the tax imposed by section 243 or 246, the term "net income", as used

in this subdivision means net income as defined in sections 245 and 246, respectively.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner, who shall redetermine the amount of the income, war-profits and excess-profits taxes for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credit.

(d) If a domestic corporation makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer.

(e) For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided*, That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such

dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the acse of a foreign corporaation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation.

Corporation Returns

SEC. 239. (a) That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

(b) Returns made under this section shall be subject to the provisions of sections 226 and 228. When return is made under section 226 the credit provided in subdivision (b) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

(c) There shall be included in the return or appended thereto a statement of such facts as will enable the Commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated during the taxable year for which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year.

Consolidated Returns of Corporations

SEC. 240. (a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated

return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportion as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.

(c) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

(d) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *Provided,* That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

(e) Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.

Time and Place for Filing Corporate Returns

Sec. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

Taxes on Insurance Companies

Sec. 242. That when used in this title the term "life insurance com-

pany" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

SEC. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

SEC. 244. (a) That in the case of a life insurance company, the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

(b) The term "reserve funds required by law" includes, in the case of assessment insurance sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

SEC. 245. (a) That in the case of a life insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

(3) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such

part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

(4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;

(5) Investment expenses paid during the taxable year: *Provided,* That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

(6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction alowed by this paragraph shall be allowed in the cases of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such case no deduction shall be allowed the shareholder or member for the amount of such taxes;

(7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(8) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(9) In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) No deduction shall be made under paragraphs (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after de-

ducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied.

(c) In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.

SEC. 246. (a) That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

(b) In the case of an insurance company subject to the tax imposed by this section—

(1) The term "gross income" means the combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;

(2) The term "net income" means the gross income as defined in paragraph (1) of this subdivision less the deductions allowed by section 247;

(3) The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year;

(4) The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct

unearned premiums on outstanding business at the end of the taxable year;

(6) The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by section 247.

SEC. 247. (a) That in computing the net income of an insurance company subject to the tax imposed by section 246 there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in paragraph (1) of subdivision (a) of section 234;

(2) All interest as provided in paragraph (2) of subdivision (a) of section 234;

(3) Taxes as provided in paragraph (3) of subdivision (a) of section 234;

(4) Losses incurred;

(5) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(6) The amount received as dividends from corporations as provided in paragraph (6) of subdivision (a) of section 234;

(7) The amount of interest earned during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title, and the amount of interest allowed as a credit under subdivision (a) of section 236;

(8) A reasonable allowance, for the exhaustion, wear and tear of property, as provided in paragraph (7) of subdivision (a) of section 234;

(9) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 246 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) In the case of a foreign corporation the deductions allowed in

this section shall be allowed to the extent provided in subdivision (b) of section 234.

(c) Nothing in this section or in section 246 shall be construed to permit the same item to be twice deducted.

Part IV.—Administrative Provisions.

Payment of Taxes

Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as a part of such installment interest thereon at the rate of one-half of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (hereinafter called "deficiency"), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due), shall be paid

upon notice and demand by the collector. If any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector. If any part of the deficiency is due to fraud with intent to evade tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector.

(c) If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act or under prior income, excess-profits, or war-profits tax Acts, or of any taxes due under section 38 of such Act of August 5, 1909, shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this Act: *Provided*, That in the case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent: *Provided further*, That in the case of a false or fraudulent return with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes due: *Provided further*, That in cases coming within the scope of paragraph (9) of subdivision (a) of

section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision.

If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: *Provided*, That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided*, That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be sufficient notice of the amount due. In the case of each subsequent installment the collector may, within thirty days and not later than ten days before the installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment. Such notice of the collector shall be sufficient notice and sufficient demand under this section.

(f) In the case of any deficiency (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to

the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of eighteen months from the passage of this Act as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted, there shall be added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1 per centum per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-thirds of 1 per centum per month. If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per centum of the deficiency and interest on the deficiency at the rate of 1 per centum per month from the time it becomes payable in accordance with the terms of such extension.

(g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of

this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes. In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdivision there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time and tax became due.

(h) The provisions of subdivisions (e), (f) and (g) of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act.

Receipts for Taxes

Sec. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipts shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

Refunds

Sec. 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government,

and for other purposes," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided,* That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer: *Provided further,* That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section: *And provided further,* That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

Penalties

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

Returns of Payments of Dividends

Sec. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder,

the number of shares owned by him, and the amount of dividends paid to him.

Returns of Brokers

SEC. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, for such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

Information at Source

SEC. 256. That all individuals, corporations and partnerships in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1921 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

Returns to Be Public Records

SEC. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided*, That the proper officers of any State imposing an income tax may, upon request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further*, That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

Publication of Statistics

SEC. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

Collection of Foreign Items

SEC. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

Citizens of Possessions of the United States

SEC. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under his title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes," approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

Porto Rico and Philippine Islands

SEC. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

Income from Sources Within the Possessions of the United States

SEC. 262. (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

Effective Date of Title

SEC. 263. That this title shall take effect as of January 1, 1921.

TITLE III.—WAR-PROFITS AND EXCESS-PROFITS TAX FOR 1921.

PART I.—GENERAL DEFINITIONS.

SEC. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in sections 200 and 201.

PART II.—IMPOSITION OF TAX

SEC. 301. (a) That in lieu of the tax imposed by Title III of the Revenue Act of 1918, but in addition to the other taxes imposed by this Act, there shall be levied, collected and paid for the calendar year 1921 upon the net income of every corporation (except corporations taxable under subdivision (b) of this section) a tax equal to the sum of the following:

First Bracket

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

Second Bracket

40 per centum of the amount of the net income in excess of 20 per per centum of the invested capital;

(b) For the calendar year 1921 there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) of section 301 of the Revenue Act of 1918, as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit which would be applicable to such calendar year under the Revenue Act of 1918 if it had been continued in force, shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (a) of this section as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(c) In any case where the full amount of the excess-profits credit is not allowed under the first bracket of subdivision (a), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

SEC. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the limitations imposed by section 302 of the Revenue Act of 1918 (upon taxes computed under subdivision (c) of section 301 of that Act) are hereby made applicable to taxes computed under subdivision (b) of section 301 of this Act. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301 of this Act.

SEC. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in section 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided*, That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

SEC. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title or any tax imposed by Title II of the Revenue Act of 1917, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

SEC. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

PART III.—EXCESS-PROFITS CREDIT.

SEC. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation or a corporation entitled to the benefits of section 262 shall not be entitled to the specific exemption of $3,000.

PART IV.—NET INCOME.

SEC. 320. That for the purpose of this title the net income of a corporation shall be ascertained and returned for the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

PART V.—INVESTED CAPITAL.

SEC. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret processes and formulae, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the

interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326 and section 331.

(b) For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided,* That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided,* That in no

case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall be the same fractional part of such average invested capital.

SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) That in the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262

the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amounts and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

Part VI.—Reorganizations.

Sec. 331. That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided*, That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

Part VII.—Miscellaneous.

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1920 and ending

in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918, which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such taxable year by the Revenue Act of 1918 shall be credited towards the payment of the tax as above computed, and if the amount so paid exceeds the amount of such tax, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252 of this Act.

(b) If a corporation (other than a personal service corporation) makes a return for a fiscal year beginning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period.

SEC. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

SEC. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the prinicipal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

Effective Date of Title

SEC. 338. That this title shall take effect as of January 1, 1921.

TITLE IV.—ESTATE TAX.

SEC. 400. That when used in this title—

The term "executor" means the executor or administrator of the decedent, or, if there is no executor or administrator, any person in actual or constructive possession of any property of the decedent;

The term "net estate" means the net estate as determined under the provisions of section 403;

The term "month" means calendar month; and

The term "collector" means the collector of internal revenue of the district in which was the domicile of the decedent at the time of his death, or, if there was no such domicile in the United States, then the collector of the district in which is situated the part of the gross estate of the decedent in the United States, or, if such part of the gross estate is situated in more than one district, then the collector of internal revenue of such district as may be designated by the Commissioner.

SEC. 401. That, in lieu of the tax imposed by Title IV of the Revenue Act of 1918, a tax equal to the sum of the following percentages of the value of the net estate (determined as provided in section 403) is hereby imposed upon the transfer of the net estate of every decedent dying after the passage of this Act, whether a resident or nonresident of the United States:

1 per centum of the amount of the net estate not in excess of $50,000;

2 per centum of the amount by which the net estate exceeds $50,000 and does not exceed $150,000;

3 per centum of the amount by which the net estate exceeds $150,000 and does not exceed $250,000;

4 per centum of the amount by which the net estate exceeds $250,000 and does not exceed $450,000;

6 per centum of the amount by which the net estate exceeds $450,000 and does not exceed $750,000;

8 per centum of the amount by which the net estate exceeds $750,000 and does not exceed $1,000,000;

10 per centum of the amount by which the net estate exceeds $1,000,000 and does not exceed $1,500,000;

12 per centum of the amount by which the net estate exceeds $1,500,000 and does not exceed $2,000,000;

14 per centum of the amount by which the net estate exceeds $2,000,000 and does not exceed $3,000,000;

16 per centum of the amount by which the net estate exceeds $3,000,000 and does not exceed $4,000,000;

18 per centum of the amount by which the net estate exceeds $4,000,000 and does not exceed $5,000,000;

20 per centum of the amount by which the net estate exceeds $5,000,000 and does not exceed $8,000,000;

22 per centum of the amount by which the net estate exceeds $8,000,000 and does not exceed $10,000,000; and

25 per centum of the amount by which the net estate exceeds $10,000,000.

The taxes imposed by this title or by Title II of the Revenue Act of 1916 (as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917) or by Title IX of the Revenue Act of 1917, or by Title IV of the Revenue Act of 1918, shall not apply to the transfer of the net estate of any decedent who has died or may die from injuries received

or disease contracted in line of duty while serving in the military or naval forces of the United States in the war against the German Government, or to the transfer of the net estate of any citizen of the United States who has died or may die from injuries received or disease contracted in line of duty while serving in the military or naval forces of any country while associated with the United States in the prosecution of such war, or prior to the entrance therein of the United States, and any tax collected upon such transfer shall be refunded to the estate of such decedent.

SEC. 402. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

(a) To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate;

(b) To the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower, curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy;

(c) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act), except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title;

(d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than a fair consideration in money or money's worth: *Provided*, That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than a fair consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person: *Provided further*, That where any property has been acquired by gift, bequest, devise, or inheritance, as a tenancy in the entirety by the decedent and spouse, or where so acquired by the decedent and any other person as joint tenants and their interests are not otherwise specified or fixed by law, then to the extent of one-half of the value thereof;

(e) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, except in case of a bona fide sale for a fair consideration in money or money's worth; and

(f) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.

Sec. 403. That for the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a resident, by deducting from the value of the gross estate—

(1) Such amounts for funeral expenses, administration expenses, claims against the estate, unpaid mortgages upon, or any indebtedness in respect to, property (except, in the case of a resident decedent, where such property is not situated in the United States), losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated for by insurance or otherwise, and such amounts reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent, as are allowed by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered, but not including any income taxes upon income received after the death of the decedent, or any estate, succession, legacy, or inheritance taxes;

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided*, That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in the decedent's gross estate and not deducted under paragraphs (1) or (3) of subdivision (a) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916;

(3) The amount of all bequests, legacies, devices, or transfers, except bona fide sales for a fair consideration in money or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any

State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious, charitable, scientific, literary, or educational purposes. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917; and

(4) An exemption of $50,000;

(b) In the case of a nonresident, by deducting from the value of that part of his gross estate which at the time of his death is situated in the United States—

(1) That proportion of the deductions specified in paragraph (1) of subdivision (a) of this section which the value of such part bears to the value of his entire gross estate, wherever situated, but in no case shall the amount so deducted exceed 10 per centum of the value of that part of his gross estate which at the time of his death is situated in the United States;

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided*, That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in that part of the decedent's gross estate which at the time of his death is situated in the United States and not deducted under paragraphs (1) or (3) of subdivision (b) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916; and

(3) The amount of all bequests, legacies, devises or transfers, except bona fide sales for a fair consideration, in money, or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious,

charitable, scientific, literary, or educational purposes within the United States. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917.

No deduction shall be allowed in the case of a nonresident unless the executor includes in the return required to be filed under section 404 the value at the time of his death of that part of the gross estate of the nonresident not situated in the United States.

For the purpose of this title stock in a domestic corporation owned and held by a nonresident decedent shall be deemed property within the United States, and any property of which the decedent has made a transfer or with respect to which he has created a trust, within the meaning of subdivision (c) of section 402, shall be deemed to be situated in the United States, if so situated either at the time of the transfer or the creation of the trust, or at the time of the decedent's death.

The amount receivable as insurance upon the life of a nonresident decedent, and any moneys deposited with any person carrying on the banking business, by or for a nonresident decedent who was not engaged in business in the United States at the time of his death, shall not, for the purpose of this title, be deemed property within the United States.

Missionaries duly commissioned and serving under boards of foreign missions of the various religious denominations in the United States, dying while in the foreign missionary service of such boards, shall not, by reason merely of their intention to permanently remain in such foreign service, be deemed nonresidents of the United States, but shall be presumed to be residents of the State, the District of Columbia, or the Territories of Alaska or Hawaii wherein they respectively resided at the time of their commission and their departure for such foreign service.

In the case of any estate in respect to which the tax has been paid, if necessary to allow the benefit of the deduction under paragraphs (2) and (3) of subdivision (a) or (b) the tax shall be redetermined and any excess of tax paid shall be refunded to the executor.

Sec. 404. That the executor, within two months after the decedent's death, or within a like period after qualifying as such, shall give written notice thereof to the collector. The executor shall also, at such times and in such manner as may be required by regulations made pursuant to law, file with the collector a return under oath in duplicate, setting forth (a) the value of the gross estate of the decedent at the time of his death, or in case of a nonresident, of that part of his gross estate situated in the United States; (b) the deductions allowed under section 403; (c) the value of the net estate of the decedent as defined in section 403; and (d) the tax paid or payable thereon; or such part of such information as may at the time be ascertainable and such supplemental data as may be necessary to establish the correct tax.

Returns shall be made in all cases where the gross estate at the death of the decedent exceeds $50,000, and in the case of the estate of every nonresident any part of whose gross estate is situated in the United States.

If the executor is unable to make a complete return as to any part of the gross estate of the decedent, he shall include in his return a description of such part and the name of every person holding a legal or beneficial interest therein, and upon notice from the collector such person shall in like manner make a return as to such part of the gross estate. The Commissioner shall make all assessments of the tax under the authority of existing administrative special and general provisions of law relating to the assessment and collection of taxes.

Sec. 405. That if no administration is granted upon the estate of a decedent, or if no return is filed as provided in section 404, or if a return contains a false or incorrect statement of a material fact, the collector or deputy collector shall make a return and the Commissioner shall assess the tax thereon.

Sec. 406. That the tax shall be due and payable one year after the decedent's death; but in any case where the Commissioner finds that payment of the tax within such period would impose undue hardship upon the estate, he may grant an extension or extensions of time for payment not to exceed three years from the due date.

The executor shall pay the tax to the collector or deputy collector, and to such portion of the tax, not paid within one year and six months after the decedent's death, interest at the rate of 6 per centum per annum from the expiration of one year after such death shall be added as part of the tax irrespective of any extension or extensions of time that may have been granted for the payment of the tax, or any portion thereof.

Sec. 407. That where the amount of tax shown upon a return made in good faith has been fully paid, or time for payment has been extended, as provided in section 406, beyond one year and six months after the decedent's death, and an additional amount of tax is, after the expiration of such period of one year and six months, found to be due, then such additional amount shall be paid upon notice and demand by the collector, and if it remains unpaid for one month after such notice and demand there shall be added as part of the tax interest on such additional amount at the rate of 10 per centum per annum from the expiration of such period until paid, and such additional tax and interest shall, until paid, be and remain a lien upon the entire gross estate.

The collector shall grant to the person paying the tax duplicate receipts, either of which shall be sufficient evidence of such payment, and shall entitle the executor to be credited and allowed the amount thereof by any court having jurisdiction to audit or settle his accounts.

If the executor files a complete return and makes written application to the Commissioner for determination of the amount of the tax and discharge from personal liability therefor, the Commissioner, as soon as possible and in any event within one year after receipt of such application, shall notify the executor of the amount of the tax, and upon payment thereof the executor shall be discharged from personal liaibility for any

additional tax thereafter found to be due, and shall be entitled to receive a receipt or writing showing such discharge: *Provided, however,* That such discharge shall not operate to release the gross estate from the lien of any additional tax that may hereafter be found to be due while the title to such gross estate remains in the heirs, devisees, or distributees thereof; but no part of such gross estate shall be subject to such lien or to any claim or demand for any such tax if the title thereto has passed to a bona fide purchaser for value.

SEC. 408. That if the tax herein imposed is not paid on or before the due date thereof the collector shall, upon instruction from the Commissioner, proceed to collect the tax under the provisions of general law, or commence appropriate proceedings in any court of the United States, in the name of the United States, to subject the property of the decedent to be sold under the judgment or decree of the court. From the proceeds of such sale the amount of the tax, together with the costs and expenses of every description to be allowed by the court, shall be first paid, and the balance shall be deposited according to the order of the court, to be paid under its direction to the person entitled thereto.

If the tax or any part thereof is paid by, or collected out of that part of the estate passing to or in the possession of, any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts, or other charges against the estate, it being the purpose and intent of this title that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution. If any part of the gross estate consists of proceeds of policies of insurance upon the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds, in excess of $40,000, of such policies bear to the net estate. If there is more than one such beneficiary the executor shall be entitled to recover from such beneficiaries in the same ratio.

SEC. 409. That unless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent, except that such part of the gross estate as is used for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof, shall be divested of such lien. If the Commissioner is satisfied that the tax liability of an estate has been fully discharged or provided for, he may, under regulations prescribed by him with the approval of the Secretary, issue his certificate, releasing any or all property of such estate from the lien herein imposed.

If (a) the decedent makes a transfer of, or creates a trust with re-

spect to, any property in contemplation of or intended to take effect in possession or enjoyment at or after his death (except in the case of a bona fide sale for a fair consideration in money or money's worth) or (b) if insurance passes under a contract executed by the decedent in favor of a specific beneficiary, and if in either case the tax in respect thereto is not paid when due, then the transferee, trustee, or beneficiary shall be personally liable for such tax, and such property, to the extent of the decedent's interest therein at the time of such transfer, or to the extent of such beneficiary's interest under such contract of insurance, shall be subject to a like lien equal to the amount of such tax. Any part of such property sold by such transferee or trustee to a bona fide purchaser for a fair consideration in money or money's worth shall be divested of the lien and a like lien shall then attach to all the property of such transferee or trustee, except any part sold to a bona fide purchaser for a fair consideration in money or money's worth.

SEC. 410. That whoever knowingly makes any false statement in any notice or return required to be filed under this title shall be liable to a penalty of not exceeding $5,000, or imprisonment not exceeding one year, or both.

Whoever fails to comply with any duty imposed upon him by section 404, or, having in his possession or control any record, file, or paper, containing or supposed to contain any information concerning the estate of the decedent, or, having in his possession or control any property comprised in the gross estate of the decedent, fails to exhibit the same upon request to the Commissioner or any collector or law officer of the United States, or his duly authorized deputy or agent, who desires to examine the same in the performance of his duties under this title, shall be liable to a penalty of not exceeding $500, to be recovered, with costs of suit, in a civil action in the name of the United States.

SEC. 411. (a) That the term "resident" as used in this title includes a citizen of the United States with respect to whose property any probate or administration proceedings are had in the United States Court for China. Where no part of the gross estate of such decedent is situated in the United States at the time of his death, the total amount of tax due under this title shall be paid to or collected by the clerk of such court, but where any part of the gross estate of such decedent is situated in the United States at the time of his death, the tax due under this title shall be paid to or collected by the collector of the district in which is situated the part of the gross estate in the United States, or, if such part is situated in more than one district, then the collector of such district as may be designated by the Commissioner.

(b) For the purpose of this section the clerk of the United States Court for China shall be a collector for the territorial jurisdiction of such court, and taxes shall be collected by and paid to him in the same manner and subject to the same provisions of law, including penalties, as the taxes collected by and paid to a collector in the United States.

(c) The proviso in the Act entitled "An Act making appropriation for the Diplomatic and Consular Service for the fiscal year ending June 30, 1921," approved June 4, 1920, which reads as follows: "*Provided*, That in probate and administration proceedings there shall be collected by said clerk, before entering the order of final distribution, to be paid into the Treasury of the United States, the same inheritance taxes from time to time collected under the laws enacted by the Congress of the United States from the estates of decedents residing within the territorial jurisdiction of the United States," is hereby repealed.

TITLE X.—SPECIAL TAXES.

Capital Stock Tax

SEC. 1000. (a) That on and after July 1, 1922, in lieu of the tax imposed by section 1000 of the Revenue Act of 1918—

(1) Every domestic corporation shall pay annually a special excise tax with respect to carrying on or doing business, equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included;

(2) Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June 30.

(b) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or, in the case of a foreign corporation, not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231, nor to any insurance company subject to the tax imposed by section 243 or 246.

(c) Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

TITLE XIII.—GENERAL ADMINISTRATIVE PROVISIONS.

Laws Made Applicable

SEC. 1300. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns,

and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

Penalties

Sec. 1302. (a) That any person required under Titles V, VI, VII, VIII, IX, X, or XII, to pay, or to collect, account for and pay over any tax, or required by law or regulations made under authority thereof to make a return or supply any information for the purposes of the computation, assessment, or collection of any such tax, who fails to pay, collect, or truly account for and pay over any such tax, make any such return or supply any such information at the time or times required by law or regulation shall in addition to other penalties provided by law be subject to a penalty of not more than $1,000.

(b) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax, shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

(c) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax shall in addition to other penalties provided by law be liable to a penalty of the amount of the tax evaded, or not paid, collected, or accounted for and paid over, to be assessed and collected in the same manner as taxes are assessed and collected: *Provided, however*, That no penalty shall be assessed under this subdivision for any offense for which a penalty may be assessed under authority of section 3176 of the Revised Statutes, as amended, or for any offense for which a penalty has been recovered under section 3256 of the Revised Statutes.

(d) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Rules and Regulations

Sec. 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

The Commissioner, with such approval may by regulation provide that any return required by Titles V, VI, VII, VIII, IX, or X to be under oath may, if the amount of the tax covered thereby is not in excess of $10, be signed or acknowledged before two witnesses instead of under oath.

Fractional Parts of a Cent

Sec. 1306. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Returns

SEC. 1307. That whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

Examination of Books and Witnesses

SEC. 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Unnecessary Examinations

SEC. 1309. That no taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

Jurisdiction of Courts

SEC. 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, paper or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

(c) Paragraph Twentieth of section 24 of the Judicial Code is amended by adding at the end thereof the following new paragraph:

"Concurrent with the Court of Claims, of any suit or proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected

without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal-revenue laws, even if the claim exceeds $10,000, if the collector of internal-revenue by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."

Amendments to Revised Statutes

SEC. 1311. That sections 3164, 3165, 3167, 3172, 3173 and 3176 of the Revised Statutes, as amended, are reenacted, without change, as follows:

"SEC. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"SEC. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"SEC. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"SEC. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects

liable to pay any tax, and to make a list of such persons and enumerate said objects.

"SEC. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided,* That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, articles or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further,* That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or a deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post office, a note or memorandum, addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized Government officer to examine the books of such person, firm, or corporation, it shall be unlawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may

deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: *Provided,* That 'person,' as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commisioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false and fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

Final Determinations and Assessments

Sec. 1312. That if after a determination and assessment in any case

the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

Administrative Review

SEC. 1313. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal-revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.

Retroactive Regulations

SEC. 1314. That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

Refunds

SEC. 1315. That section 3220 of the Revised Statutes, as amended, is reenacted without change, as follows:

"SEC. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

SEC. 1316. That section 3228 of the Revised Statutes is amended to read as follows:

"SEC. 3228. All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum."

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

SEC. 1317. That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal revenue laws," is repealed from and after June 30, 1920; and the Secretary and Treasury shall submit for the fiscal year 1921 and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Limitations upon Suits and Prosecutions

SEC. 1318. That section 3226 of the Revised Statutes is amended to read as follows:

"SEC. 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of five years from the date of the payment of such tax penalty, or sum."

This section shall not affect any suit or proceeding instituted prior to the passage of this Act, but shall apply to all suits and proceedings instituted after the passage of this Act, whether or not barred by prior Acts of Congress.

SEC. 1319. That section 3227 of the Revised Statutes is hereby repealed but such repeal shall not affect any suit or proceeding instituted prior to the passage of this Act.

SEC. 1320. That no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five years from

the time such tax was due, except in the case of fraud with intent to evade tax, or willful attention in any manner to defeat or evade tax. This section shall not apply to suits or proceedings for the collection of taxes under section 250 of this Act, nor to suits or proceedings begun at the time of the passage of this Act.

SEC. 1321. (a) That the Act entitled "An Act to limit the time within which prosecutions may be instituted against persons charged with violating internal-revenue laws," approved July 5, 1884, is amended to read as follows:

"That no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense: *Provided,* That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings: *Provided further,* That the provisions of this Act shall not apply to offenses committed prior to its passage: *Provided further,* That where a complaint shall be instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district: *And provided further,* That this Act shall not apply to offenses committed by officers of the United States."

(b) Any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceeding shall be subject to the limitations imposed by law prior to the passage of this Act.

Assessments

SEC. 1322. That all internal revenue taxes, except as provided in section 250 of this Act, shall, notwithstanding the provisions of section 3182 of the Revised Statutes or any other provision of law, be assessed within four years after such taxes became due, but in the case of fraud with intent to evade tax or willful attempt in any manner to defeat or evade tax, such tax may be assessed at any time.

Fraudulent Returns

SEC. 1323. That section 3225 of the Revised Statutes of the United States, as amended, is reenacted without change as follows:

"SEC. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not

willfully false or fraudulent and did not contain any willful understatement or undervaluation."

Interest on Refunds and Judgments

SEC. 1324. (a) That upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest shall be allowed and paid upon the total amount of such refund or credit at the rate of one-half of 1 per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest setting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" as used in this section means a further assessment for a tax of the same character previously paid in part.

(b) Section 177 of the Judicial Code is amended to read as follows:

"SEC. 177. No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal-revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal-revenue laws."

Payment of Taxes by Check or United States Securities

SEC. 1325. That collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

Frauds on Purchasers

SEC. 1326. That whoever in connection with the sale of lease, or offer for sale or lease, of any article, or for the purpose of making such sale or lease, makes any statement, written or oral, (1) intended or calculated to lead any person to believe that any part of the price at which such article is sold or leased, or offered for sale or lease, consists of a tax imposed under the authority of the United States, or (2) ascribing a

particular part of such price to a tax imposed under the authority of the United States, knowing that such statement is false or that the tax is not so great as the portion of such price ascribed to such tax, shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not more than $1,000 or by imprisonment not exceeding one year, or both.

Tax Simplification Board

Sec. 1327. (a) That there is hereby established in the Department of the Treasury a board to be known as the "Tax Simplification Board" (hereinafter in this section called the "Board"), to be composed as follows:

(1) Three members who shall represent the public, to be appointed by the President; and

(2) Three members who shall represent the Bureau of Internal Revenue and shall be officers or employees of the United States serving in such Bureau, to be appointed by the Secretary.

(b) Any vacancy in the Board shall be filled in the same manner as the original appointment. The members representing the public shall serve without compensation except reimbursement for traveling, subsistence, and other necessary expenses incurred in the performance of the duties vested in them by this section. The members representing the Bureau of Internal Revenue shall serve without compensation in addition to that received for their service in such Bureau.

(c) The Secretary shall furnish the Board with such clerical assistance, quarters and stationery, furniture, office equipment, and other supplies as may be necessary for the performance of the duties vested in them by this section.

(d) It shall be the duty of the Board to investigate the procedure of and the forms used by the Bureau in the administration of the internal revenue laws, and to make recommendations in respect to the simplification thereof. The Board shall make a report to the Congress on or before the first Monday of December in each year.

(e) The expenditures of the Board shall be paid upon vouchers approved by the Board and signed by the chairman thereof. For the expenditures of the Board for the fiscal year ending June 30, 1922, there is authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the sum of $10,000.

(f) The Board shall cease to exist on December 31, 1924.

Consolidation of Liberty Bond Tax Exemptions

Sec. 1328. That the various Acts authorizing the issues of Liberty bonds are amended and supplemented as follows:

(a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or

profits of individuals, partnerships, corporations, or associations in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German Government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

Deposit of United States Bonds or Notes in Lieu of Surety

SEC. 1329. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking, hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds or notes of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds or notes so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds or notes in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds or notes deposited hereunder and such other United States bonds or notes as may be substituted therefor from time to time as such security, may be deposited with the Treasurer of the United States, a Federal reserve bank, or other depositary duly designated for that purpose by the Secretary, which shall issue receipt therefor, describing such bonds or notes so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds or notes so deposited, shall be returned to the depositor: *Provided,* That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat. 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'An Act for the protection of persons furnishing materials and labor for the construction of public works,'" shall file with the obligee, at any time after a default in the performance of any contract subject to

said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds or notes nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or notes or proceeds subject to the order of the court having jurisdiction thereof: *Provided further,* That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds or notes deposited or any right or remedy granted by said Acts or by this section to the United States for default upon any obligation of said penal bonds: *Provided further,* That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof: *And provided further,* That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

Lost Stamps for Tobacco, Cigars, and So Forth

SEC. 1330. That section 3315 of the Revised Statutes, as amended, is reenacted without change, as follows:

"SEC. 3315. The Commissioner of Internal Revenue may, under regulations prescribed by him with the approval of the Secretary of the Treasury, issue stamps for restamping packages of distilled spirits, tobacco, cigars, snuff, cigarettes, fermented liquors, and wines which have been duly stamped but from which the stamps have been lost or destroyed by unavoidable accident."

Consolidated Returns for Year 1917

SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided,* That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or

partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

Alternative Tax on Personal Service Corporations

Sec. 1332. (a) That if either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is by final adjudication declared invalid, there shall, in addition to all other taxes, be levied, collected, and paid on the net income (as defined in section 232) received during the calendar years 1918, 1919, 1920, and 1921, by every personal service corporation (as defined in section 200) included within the provisions of such subdivisions, a tax equal to the taxes imposed by Titles II and III of the Revenue Act of 1918 and, in the case of income received during the calendar year 1921, by Titles II and III of this Act.

(b) In such event every such personal service corporation shall, on or before the fifteenth day of the sixth month following the date of entry of decree upon such final adjudication, make a return of any income received during each of the calendar years 1918, 1919, 1920, and 1921 in the manner prescribed by the Revenue Act of 1918 (or in the manner prescribed by this Act, in the case of income received during the calendar year 1921). Such return shall be made and the net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in the manner provided for other corporations under the Revenue Act of 1918 and this Act.

(c) If either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is so declared invalid, claims for credit or refund of taxes paid under both such sections shall be allowed, if made within the time provided in subdivision (f) of this section.

(d) In case the claims for credit or refund, filed within six months from such date of entry of decree, represent less than 30 per centum of the outstanding stock or shares in the corporation, the amount of taxes imposed by this section upon such corporation shall be reduced to that proportion thereof which the number of stock or shares owned by the shareholders or members making such claims bears to the total number of stock or shares outstanding.

(e) The tax imposed by this section shall be assessed, collected, and paid upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the taxes imposed by sections 230 and 301 of the Revenue Act of 1918 (or by sections 230 and 301 of this Act, in the case of income received during the calendar year 1921), but no interest or penalties shall be due or payable thereon for any period prior to the date upon which the return is by this section required to be made and the first installment paid. The amount of tax paid by any shareholder or member of a personal service corporation pursuant to the provisions of subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act shall be credited against the tax due from such corporation under this section upon the joint written application of such corporation and such shareholder or member of his representatives, heirs, or assigns, if such application is filed with the Commissioner within six months from such date of entry of decree.

(f) Notwithstanding any other provision of law, no claim for a credit or refund of taxes paid under subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act, may be filed after the expiration of six months from such date of entry of decree: *Provided, however*, That a personal service corporation of which no shareholder or member has filed such claim within such period of six months shall not be subject to the tax imposed by this section.

TITLE XIV.—GENERAL PROVISIONS

Repeals

SEC. 1400. (a) That the following parts of the Revenue Act of 1918 are repealed, to take effect (except as otherwise provided in this Act) on January 1, 1922, subject to the limitations provided in subdivision (b):

Title II (called "Income Tax") as of January 1, 1921;

Title III (called "War-Profits and Excess-Profits Tax") as of January 1, 1921;

Title IV (called "Estate Tax") on the passage of this Act;

Title X (called "Special Taxes");

Sections 1314, 1315, 1316, 1317, 1319, and 1320 of Title XIII (being certain administrative provisions) on the passage of this Act.

(b) The parts of the Revenue Act of 1918 which are repealed by this Act shall (unless otherwise specifically provided in this Act) remain in force for the assessment and collection of all taxes which have accrued under the Revenue Act of 1918 at the time such parts cease to be in effect, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any such taxes. In the case of any tax imposed by any part of the Revenue Act of 1918 repealed by this Act, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under

this Act takes effect under the provisions of this Act. The unexpended balance of any appropriation heretofore made and now available for the administration of any such part of the Revenue Act of 1918 shall be available for the administration of this Act or the corresponding provision thereof.

Increase in Treasury Savings Certificate Limit

SEC. 1402. That section 6 of the Second Liberty Bond Act, as amended, is amended by striking out in the next to the last sentence thereof the figures "$1,000" and inserting in lieu thereof the figures "$5,000."

Saving Clause in Event of Unconstitutionality

SEC. 1403. That if any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of the Act, and the application of such provision to other persons or circumstances, shall not be affected thereby.

Effective Date of Act.

SEC. 1404. That except as otherwise provided, this Act shall take effect upon its passage.

Approved, November 23, 1921, at 3.55 p. m.

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